DEPARTMENT OF STATE REVENUE

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Letter of Findings: 18-20100720; 18-20110569
Financial Institutions Tax
For the Years 2006, 2007, and 2008

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ISSUES

I. Merchant Discount – Financial Institutions Tax

Authority: IC § 6-5.5-1-12; IC § 6-5.5-1-13; IC § 6-5.5-1-17; IC § 6-5.5-1-17(a)(2); IC § 6-5.5-1-17(a)(4); IC § 6-5.5-1-17(d)(2)(A); IC § 6-5.5-1-17(d)(2)(C); IC § 6-5.5-4-8; IC § 6-8.1-5-1(c); 45 IAC 17-2-1; Economy Oil Corp. v. Ind. Dep't of State Revenue, 162 Ind. App. 658, 321 N.E.2d 215 (1974); Dep't of Treasury of Ind. v. Dietzen's Estate, 215 Ind. 528, 21 N.E.2d 137 (1939); Fell v. West, 73 N.E. 719 (Ind. App. 1905); Capital One Financial Corp. v. Comm'r., 133 T.C. 136 (U.S. Tax Ct. 2009); I.R.C. § 61; Abbot B. Lipsky, Improving Competitive Analysis, 16 Geo. Mason L. Rev. 805 (2009); Steven Semeraro, The Antitrust Economics (and Law) of Surcharging Credit Transactions, 14 Stan. J.L. Bus. & Fin. 343 (2009); Gregory M. Duhl, International Developments in Consumer Financial Services Law, 64 Bus. Law. 677 (2009); Steven Semeraro, Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty, 14 Geo. Mason L. Rev. 941 (2007).

Taxpayer argues that the Department erred in reducing its receipts apportionment factor by netting its merchant credit card fees by its "merchant discount" receipts.

II. Combined Return – Financial Institutions Tax

Authority: IC § 6-5.5-1-12; IC § 6-5.5-1-13; IC § 6-5.5-1-17(a)(2); IC § 6-5.5-1-17(a)(4); IC § 6-5.5-1-17(d); IC § 6-5.5-1-17(d)(2); IC § 6-5.5-1-17(d)(2)(A); IC § 6-5.5-1-18; IC § 6-5.5-1-18(a); IC § 6-5.5-2-4; IC § 6-5.5-2-8; IC § 6-5.5-2-8(a); IC § 6-5.5-2-8(a)(1), (2); IC § 6-5.5-2-8(a)(2); IC § 6-5.5-3-1; IC § 6-5.5-3-1(6); IC § 6-5.5-3-8; IC § 6-5.5-3-8(5); IC § 6-5.5-3-8(5)(C); IC § 6-8.1-5-1(c); 45 IAC 17-2-1; Black's Law Dictionary (7th ed. 1999).

Taxpayer maintains that the Department's audit incorrectly determined that certain related entities should be included in Taxpayer's combined tax return.

III. Apportionment Methodology – Financial Institutions Tax

Authority: IC § 6-5.5-1-18; IC § 6-5.5-2-1; IC § 6-5.5-2-3; IC § 6-5.5-2-4; IC § 6-5.5-2-8; IC § 6-5.5-5-1; IC § 6-5.5-5-2; IC § 6-8.1-5-1; IC § 6-8.1-5-1(c); 45 IAC 17-2-1; P.L. 68-1991; State ex rel. Hatcher v. Lake Super. Ct., Room Three, 500 N.E.2d 737 (Ind. 1986); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Department of State Revenue v. Estate of Hardy, 703 N.E.2d 705 (Ind. Tax Ct. 1998); Associated Ins. Cos., Inc. v. Indiana Dep't of State Revenue, 655 N.E.2d 1271 (Ind. Tax Ct. 1995); Letter of Findings 18-20091022 (June 25, 2010); Letter of Findings 18-20070618 (September 29, 2008); Letter of Findings 18-20070206 (September 11, 2007).

Taxpayer sets out a secondary argument on the ground that even if "Mortgage II" – as identified in Part II above – was transacting the business of a financial institution, whether "Mortgage II" should be included in the combined return, and that – if included – the amount of taxable income must be computed based on a "post-apportionment" basis.

IV. Combined Return – Financial Institutions Tax

Authority: IC § 6-5.5-2-1(a); IC § 6-5.5-1-17(b); IC § 6-5.5-1-17(b)(1); IC § 6-5.5-1-18(a); IC § 6-5.5-3-1(6).

Taxpayer states that the Department's audit should have included in its combined tax return Taxpayer's Community Development Corporation.

V. Foreign Source Income Losses – Financial Institutions Tax

Authority: IC § 6-5.5-1-2(a); IC § 6-5.5-1-2(a)(2)(B); I.R.C. § 862(a); I.R.C. § 862(b).

Taxpayer argues that the Department erred in its treatment of the Taxpayer's foreign source income deduction.

VI. Apportionment Numerator – Financial Institutions Tax

Authority: IC § 6-5.5-4-4; IC § 6-5.5-4-10.

Taxpayer claims that the Department made an error in sourcing its "loan servicing fees" to Indiana.

VII. Underpayment Penalty – Financial Institutions Tax

Authority: IC § 6-5.5-6-3; IC § 6-5.5-7-1.

Taxpayer challenges the Department's imposition of a ten-percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of providing financial services to commercial and individual customers. Taxpayer's various subsidiaries offer its customers mortgage, automobile financing, leasing, investment, trust, and brokerage services. Taxpayer conducts this business, at least in part, by operating full service banking locations within Indiana.

The Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional Financial Institutions Tax ("FIT").

Taxpayer objected to a portion of the assessment and submitted a protest to that effect. A series of administrative hearings was conducted during which Taxpayer's representatives explained the basis for the objections. This Letter of Findings results.

I. Merchant Discount – Financial Institutions Tax

DISCUSSION

Taxpayer explains that "During the taxable years under examination, the Taxpayer acted as a 'Merchant Bank' processing credit card transactions submitted by merchants who accepted credit cards for payment of goods and services [the merchants] sold." The Department's audit reduced the "credit card merchant fees" originally reported by Taxpayer in the numerator and denominator of its combined apportionment factor. The audit report explains that the "adjustment includes the [T]axpayer's interchange contra revenue accounts in determining the [T]axpayer's true gross income from merchant fees."

The FIT is imposed on both "nonresident" and "resident taxpayers" transacting business within Indiana. IC § 6-5.5-1-12, 13. IC § 6-5.5-1-12 defines a "nonresident taxpayer" as a "taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana."

45 IAC 17-2-1 explains that the FIT is "intended to tax both traditional financial institutions that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana."

For purposes of the FIT, a corporation that is transacting the business of a financial institution includes a regulated financial corporation, IC § 6-5.5-1-17(a)(2), any other corporation that is carrying on the business of a financial institution, IC § 6-5.5-1-17(a)(4), and specifically includes "[m]aking, acquiring, selling, or servicing loans or extensions of credit." IC § 6-5.5-1-17(d)(2)(A). The provision also includes, "Operating a credit card, debit card, charge card, or similar business." IC § 6-5.5-1-17(d)(2)(C).

Taxpayer objects primarily on the ground that the Department's audit "misunderstands the nature of the interchange fee which is actually an expense incurred by [Taxpayer] that in no way reduces its gross income from the merchant discount."

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." In construing tax statutes a liberal rule of interpretation must be indulged in order to aid the taxing power of the state. Dep't of Treasury of Ind. v. Dietzen's Estate, 215 Ind. 528, 532, 21 N.E.2d 137, 139 (1939). See also Economy Oil Corp. v. Ind. Dep't of State Revenue, 162 Ind. App. 658, 665, 321 N.E.2d 215, 218 (1974) ("In construing tax statutes relating to assessment and collection, a liberal rule of construction must be indulged in order to secure their uniform implementation.") The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers. Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905).

Before discussing the substantive matters at issue, it is important to understand that a merchant contracts with a single "Merchant Bank" to process all of the merchant's credit card transactions during the normal course of the Merchant's day-to-day business. As a preliminary matter it is appropriate to define the following terms as they will be used in this Letter of Findings.

- A "Merchant Bank" is a financial institution which contracts with a "Merchant" to provide the merchant with credit card acceptance and processing services; the term "acquiring bank" is synonymous with "Merchant Bank."
- The "Cardholder" is an individual who holds and uses a credit card.
- The "Merchant" is a retailer or service provider who accepts a cardholder's credit card.
- The "Issuing Bank" is a bank or other financial institution which issues the Cardholder the credit card. The name of the "Issuing Bank" is typically imprinted on the Cardholder's credit card; the Issuing Bank has a direct relationship with the Cardholder.

Additional terms require further explanation but an outline of the steps involved in a simple credit card transaction along with a description of the credit card infrastructure helps to clarify the issue.

There are two types of credit cards systems: "unitary systems" which issue all of their own cards and sign up virtually all their own merchants and "association systems" such as Visa and MasterCard which are entities which do not deal directly with cardholders or merchants. Instead, in an "association system" large numbers of banks – such as Taxpayer – compete to function as either Issuing Banks and/or acquiring banks. Steven Semeraro, Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty, 14 Geo. Mason L. Rev. 941, 946-47 (2007). "Potentially, the cardholder and merchant involved in a particular transaction could be clients of the same bank. But most Visa or MasterCard transactions will involve four parties: (1) the cardholder and (2) the Issuing Bank, on the one hand, and (3) the merchant and (4) its acquiring bank, on the other." Id. In an "association system," the banks compete for both cardholders and merchants. Capital One Financial Corp. v. Comm'r, 133 T.C. 136, 143

(U.S. Tax Ct. 2009). "The association members agreed that a cardholder carrying a card issued by any member bank could use the card at a merchant signed up by any member bank." Id.

The term "acquiring bank" and "Merchant Bank" are – for purposes of this Letter of Findings – treated synonymously; for purposes of simplicity and consistency, the term "Merchant Bank" will generally be used hereinafter.

As mentioned previously, a typical credit card transaction involves four parties: Cardholder, Issuing Bank, Merchant, and Merchant Bank. What follows is a brief explanatory outline of a typical credit card transaction, the parties involved in that transaction, and is generally the template under which the audit understood the transactions at issue.

- Cardholder purchases a $100 item from Merchant using a VISA/MasterCard general purpose credit card. (The association brand name "VISA/MasterCard" is used here for convenience sake.) Merchant passes on the $100 charge to its Merchant Bank with which it has previously entered into a contractual relationship to process all of the Merchant's credit card transactions. Merchant Bank sends $98 to Merchant. On its face, Merchant loses $2.00 on the transaction, but the Merchant's advantage is that it "closes its books" on that particular transaction in an expedited fashion. Taxpayer explains that "[t]he difference between the $100 transaction charge and the $98 sent to Merchant by Merchant Bank is determined by the contract between Merchant and Merchant Bank and is called the "merchant discount."
- Merchant Bank then submits the $100 charge into the VISA/MasterCard system and receives $98.50 from the Cardholder's Issuing Bank. Taxpayer explains that since Merchant Bank has already forwarded the $98 to the Merchant, Merchant Bank has "earned" $.50. This $.50 is called a "merchant discount."
- Eventually, Cardholder writes a check to its Issuing Bank for $100; since Issuing Bank has already forwarded $98.50 to the Merchant Bank, Issuing Bank has "earned" $1.50 on this particular transaction. The $1.50 earned by the Issuing Bank is called an "interchange fee." It is the attribution of this "interchange fee" which is central to the issue raised by Taxpayer.

In its most simple terms, the Cardholder is satisfied because he or she has completed an ordinary $100 purchase relying on the convenience of a credit card; the Merchant is satisfied because it has timely received money due ($98) on the transaction albeit at a slightly discounted rate; the Merchant Bank is satisfied because it has earned $.50 for validating the transaction; the Issuing Bank has earned $1.50 as an interchange fee. However, Taxpayer during the years at issue – functioning as the Merchant Bank – had recorded the $1.50 in a contra revenue account and counts both the $1.50 and $.50 cents as gross revenue; Taxpayer reports $2.00 as taxable income. The foregoing is essentially the model employed by Taxpayer.

The question of how to account for the $1.50 interchange fee is at the heart of the dispute addressed in Part I of this Letter of Findings. It should be noted that whether or not Taxpayer ever functions as an Issuing Bank is irrelevant for purposes of this Letter of Findings; this dispute solely relates to circumstances in which the Taxpayer functions as a "Merchant Bank."

The dispute centers on the treatment of the Taxpayer's purported "interchange fees." The audit report explained:

> The [T]axpayer contracts with various merchants and retailers to facilitate credit card transactions by providing equipment and processing as part of its contracted services. The [T]axpayer receives "merchant fees" from... retailers and merchants as compensation for these services. The merchant fees recorded in revenue by the taxpayer includes fees that are the income of the [T]axpayer and fees that are the income of others such as the financial institutions that issue the credit cards to the merchants and [the] retailers' customers. The [T]axpayer captures merchant fees including the component of the fees belonging to the issuing financial institutions in its "merchant fees" revenue accounts. The [T]axpayer also maintained revenue accounts that contain only the portion of the merchant fees that are due to other financial institutions in the form of interchange fees. In this case the interchange fee contra revenue accounts correspond and reduce the merchant fee revenue accounts. In the [Taxpayer's] case, the merchant fee revenue accounts are taken in conjunction with the contra revenue interchange fee accounts. When taken in tandem, an offset occurs that results in the true gross income of the [T]axpayer such that the resulting merchant fees reflect on the gross income of the [T]axpayer and not the gross income of the other financial institutions.

In its own accounting records based on the example cited above, Taxpayer was recording the $2.00 merchant discount in a gross revenue account. Taxpayer was also recording the $1.50 received by the Issuing Bank in Taxpayer's "contra" revenue account. In other words, Taxpayer counted the $2.00 as "merchant fees" attributable to the cited example. Taxpayer also recorded the $1.50 in a contra revenue account which it later effectively netted against the "merchant fees" account ($2.00 - $1.50 = $.50). In a common sense accounting of the transaction, Taxpayer (Merchant Bank) earned $.50 and Issuing Bank earned $1.50, but Taxpayer claimed both the $.50 and $1.50 as gross revenue.

The Department's audit objected stating that " [T]axpayer is reporting an amount that includes the gross income of others" concluding that "[T]axpayer's exclusion of the contra revenue accounts in determining the apportionment denominator results in the [T]axpayer reporting receipts that it never contractually owned or earned."

Taxpayer objects to the audit's conclusion stating that the example cited in the audit report – and repeated above – "does not provide the needed review of the contractual obligations and revenue recognition of a typical '4-party transaction.'" (Cardholder, Issuing Bank, Merchant, and Merchant Bank).

Taxpayer explains as follows:

> [The] merchant discount was received pursuant to agreements between the Taxpayer and its merchant customers. These agreements were negotiated between the Taxpayer and the Merchants, and the amount of the merchant discount was determined by these negotiations. The Issuing Banks were not parties to the agreement, played no role in the negotiations, and had no say in the amount of the merchant discount negotiated. According to the Taxpayer, the interchange fees are expenses paid by the Taxpayer to the Issuing Banks.

Taxpayer argues that "the terms of the interchange fees incurred by [Taxpayer] are determined by... separate agreements entered into between [Taxpayer] and the interchange networks, e.g. MasterCard and Visa." This fee "is paid to the Issuing Banks as their compensation for issuing cards and participating in the credit card system." Taxpayer further explains that, pursuant to I.R.C. § 61, its "gross income includes compensation from services including 'fees' and that there is nothing in I.R.C. § 61 that provides for a reduction in gross income for the costs that are incurred in providing the services in question." Taxpayer concludes that its gross income includes the interchange fees paid the Issuing Bank.

Taxpayer further explains as follows:

> Taxpayer relies on the Visa operating rules which state that, "Merchants do not actually pay Interchange Reimburse Fees; Merchants pay 'Merchant Discount' to their Acquirer [the] Merchant Bank." According to the Taxpayer, it is contractually entitled to the full merchant discount as payment for its services to the Merchants, and it separately incurs the interchange fees as an expense payable to the Issuing Banks under the Visa/MasterCard operating rules. The Taxpayer maintains that the calculation of its gross receipts from the merchant discount should not be reduced by an expense it incurs to the Issuing Banks. It earned the merchant discount pursuant to the Merchant, and it, not the Merchant was liable to the Issuing Bank for the interchange fee.

Taxpayer concludes that that *[sic]* it pays the interchange fees to the Issuing Bank and that it is entitled to recover the interchange fees from its Merchant customers.

Taxpayer also cites to IC § 6-5.5-4-8 as authority for its argument. The provision states in its entirety as follows:

> Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees must be attributed to the state to which the card charges and fees are regularly billed. (Emphasis added).

Taxpayer asserts that, "The plain and unambiguous language of IC § 6-5.5-4-8 states that a merchant discount is a receipt included in the apportionment factor denominator and describes how the amount of merchant discount included in the numerator is determined. There is nothing in the statute that permits the netting of the interchange fees incurred by [Taxpayer] against the merchant discount earned by [Taxpayer]...."

The Department is unable to agree that IC § 6-5.5-4-8 necessarily resolves the issue. As the Merchant Bank, Taxpayer includes the merchant discount as a "receipt included in the apportionment factor denominator." In this case, the question is more fundamental. Is the "merchant discount" the amount Taxpayer earned on each transaction – the $.50 noted in the example above – or does the merchant discount include both the $.50 and the $1.50 eventually earned by the Issuing Bank? Does Taxpayer ever have a contractual, possessory interest such that Taxpayer is entitled to include the $1.50 interchange fee as a "receipt?"

Various authorities have described the transactions at issue. For example, in Abbot B. Lipsky, Improving Competitive Analysis, 16 Geo. Mason L. Rev. 805, 817 (2009):

> In the major bank credit card systems, card-issuing banks offer credit and a convenient transaction medium to consumers; "merchant" banks enlist providers of goods and services, giving them the ability to offer a convenient transaction format for their customers, the card holders. Card holders pay interest on outstanding credit balances and/or an annual fee to use the card, while merchants honoring the card pay a fee (the "merchant discount") to their bank for "acquiring" transactions (i.e., for compensating the merchant for goods and services provided to cardholders). The acquiring bank looks to the bank that issued the card for payment, and the card-issuing bank pays the acquiring bank and bills the consumer who made the purchase, closing the loop. The acquiring bank pays an "interchange fee" to the card-issuing bank. In general, the interchange fees are set by the credit-card system, not by individual negotiation between acquiring banks and issuing banks.

The description above tends to support Taxpayer's position because the article clearly states that "[t]he acquiring bank pays an 'interchange fee' to the card issuing bank." In the example given above, the description confirms that the acquiring bank – or "Merchant Bank" – pays the Issuing Bank the $1.50 at issue. Necessarily, the Merchant Bank acquired the $1.50 at some point during the transaction because it had the $1.50 in hand to pay the Issuing Bank.

Steven Semeraro, The Antitrust Economics (and Law) of Surcharging Credit Transactions, 14 Stan. J.L. Bus.

& Fin. 343, 348-49 (2009) offers another perspective on these transactions. The article uses the term "acquirer" or "acceptance bank" to designate the "Merchant Bank."

> In a credit card system, a receipt for payment of a purchase made with a card flows from the merchant to its card acceptance bank ("acquirer") and then to the bank that issued the card. For example, when a customer makes a $100 purchase with a credit card, an acquirer would pay the merchant approximately $98. The merchant is thus paying a $2 fee for card acceptance. The card issuing bank would then pay the acquirer $98.50 for the receivable and bill the cardholder for the entire $100, plus interest if the account has a balance. From the $2.00 fee paid by the merchant, the acquirer would typically keep about $.50. The remaining $1.50, 75 percent of the revenue from the merchant, constitutes the interchange fee that is paid to the card issuing bank. The percentage of the purchase price earned by the issuer and acquirer will vary depending on the industry, type of card, and a variety of other factors. In particular, cards that pay rebates or rewards to cardholders have higher interchange fees than regular cards. In all cases, however, the issuer will always receive a substantially larger percentage of the merchant fee than the acquirer. (Internal citations omitted).

The description above does not support Taxpayer's position because the description states that the Issuing Bank pays the acquiring bank – or "Merchant Bank" – $98.50 and that acquiring bank keeps the $.50 as its merchant discount. The description does not support Taxpayer's contention that it ever has a possessory interest in the interchange fee or that it pays the interchange fee to the Issuing Bank.

Gregory M. Duhl, International Developments in Consumer Financial Services Law, 64 Bus. Law. 677, 679 (2009) describes a credit card transaction as follows:

> An interchange fee is a fee that the acquiring bank (the merchant's bank) pays the issuing bank (the consumer's bank) for a credit card transaction in certain networks such as Visa and MasterCard. The fee usually consists of a small flat amount and a percentage of the purchase total that varies based on the type of transaction and card, the merchant's industry, and the method of card acceptance. The issuing bank deducts the interchange fee from the amount that the bank pays the acquiring bank for the purchase, and the acquiring bank pays the merchant the balance minus a small fee that the bank keeps for itself.

This article seems to want it both ways; on its face, the article apparently supports Taxpayer's position stating that the Merchant Bank pays the interchange fee to the Issuing Bank but the article also states that the Issuing Bank deducts the interchange fee from the amount the Issuing Bank pays the Merchant Bank. The article neither clearly undermines nor supports Taxpayer's position.

In Capital One Financial Corp. v. Comm'r., 133 T.C. 136 (U.S. Tax Ct. 2009), the court addressed the issues related to the proper accounting of interchange fees. The court explained the relationship between the Merchant Bank, the acquiring bank, and the Visa/Mastercard infrastructure.

> Visa and MasterCard provided the infrastructure which enabled credit card transactions to take place. They processed transactions between acquiring and issuing banks, allowing purchases to be authorized. Further, the associations provided the infrastructure which allowed the parties to clear and settle millions of credit card transactions. Id. at 145.

As in the previous cited examples, the court described a typical transaction but included the function of the Visa/MasterCard infrastructure within each transaction.

> Capital One [Merchant Bank] maintained a bank account with the Federal Reserve Bank of Richmond. In accordance with their respective rules, the associations were authorized to withdraw/debit and/or deposit/credit funds into Capital One's bank account to settle Capital One's credit card transactions each day. For credit card purchase transactions, the association withdrew funds from Capital One's account and deposited funds in the corresponding acquiring bank's account. Both MasterCard and Visa were authorized to withdraw only the total price less the applicable interchange fee from Capital One's Federal Reserve Bank account.
>
> The process through which credit card purchase transactions were settled during the years at issue is shown in the illustration below. This is an example of a single credit card purchase transaction, using a total price of $100, a hypothetical 2–percent interchange fee, and a hypothetical merchant discount of 2.5 percent. The example assumes that no other transactions occurred for the cardholder, the merchant, the acquiring bank, or the issuing bank. In settlement of this hypothetical transaction:
>
> a. The association withdraws $98 from the issuing bank's account, representing the $100 total price less the 2–percent interchange fee.
>
> b. The association deposits $98 into the acquiring bank's account, also representing the $100 total price less the 2–percent interchange fee.
>
> c. The acquiring bank deposits $97.50 into the merchant's bank account, representing the $100 total price less the 2.5–percent merchant discount. Id. at 148-149.

The court held:

> Interchange is income earned by an issuer of MasterCard or Visa credit cards which accrues to the issuer every time a cardholder uses a card for a purchase. Interchange is typically calculated as a percentage of the total amount of the purchase plus, in most but not all instances, a small fixed fee. Id. at 141.

The description set out in Capital One is inconclusive but seems to suggest that the $2.00 interchange fee remains in the Issuing Bank's account and is not transferred to the Merchant Bank. Based on this description, the interchange income is earned by the Issuing Bank and constitutes income in which Merchant Bank has no interest.

The authorities cited above are inconclusive. The question of whether or not this particular Taxpayer was entitled to include the interchange fees as one portion of its gross income is resolved by considering the specific relationship between the parties involved in the transactions. For purposes of addressing this Taxpayer's protest and for purposes of this Letter of Findings, the issue is one of "fact" and not of law.

Taxpayer provided copies of the contracts it enters into with the merchants. Taxpayer enters into two basic form agreements with its merchants. Taxpayer enters into (1) "bundled" agreements in which most of the fees for Taxpayer's services are "bundled" into a single charge. In a "bundled" agreement, the fee charged the merchant by Taxpayer is "typically a percentage of the credit card charge plus a fixed fee per transaction." Taxpayer also enters into (2) "unbundled" agreements. In an "unbundled agreement," the "merchant discount is broken down into a number of subcategories, and merchant[s]... are provided with itemized statements detailing the amounts allocated to each subcategory."

It is Taxpayer's position that under both the bundled and the unbundled agreements, "[Taxpayer] is entitled to receive a fee from the merchant that is intended to cover [Taxpayer's] costs including the cost of the interchange fees it pays to Issuing Banks, and to provide it with an operating margin." (Emphasis added).

Taxpayer provided a copy of a "bundled" contract with one of its merchant customers. In the agreement, the merchant is effectively charged 2.43 percent for each transaction. In the case of a $100 transaction, the merchant pays Taxpayer $2.43 and Taxpayer reimburses merchant $97.57 on the original $100 transaction. Insofar as the $2.43 owed Taxpayer, the contract stipulates as follows:

> Merchant will pay Bank fees and charges for Services, forms, and/or equipment in accordance with the pricing detailed in the Agreement, any schedules, exhibits, or addenda incorporated or reference herein, and Bank's then-current standards.... In the event of any Card Association increases interchange, fees, or assessment [Taxpayer] may increase merchant's fees and charges to reflect such increases without notice to merchant, and merchant shall pay such increased fees and charges.

Taxpayer explains the meaning of the provision stating that, "[Taxpayer] is entitled to receive a fee from the merchant that is intended to cover [Taxpayer's] costs, including the cost of interchange fees."

Taxpayer provided a copy of an unbundled contract it has with one of its merchants. The contract provides as follows:

> Merchant agrees to pay [Taxpayer] the [Taxpayer's] fees, expenses and all other amounts set forth in the Agreement, including but not limited to the Merchant Price Schedule (collectively the "Bank Fees").
>
> An attachment to the unbundled contract defines "Network Fees" as follows:
>
> Merchant agrees to pay [Taxpayer] all then current fees, assessments, and penalties as imposed by [credit card network] if incurred on behalf of Merchant, by [Taxpayer] its affiliates and/or agents. The interchange and other fees set forth in Exhibit A are, or were in effect but are subject to change and to surcharges by [credit card network] with such charges and/or surcharges effective as determined by such organizations.... Merchant agrees to pay all fees, fines, penalties and assessments as they are currently in effect or may be changed from time to time, imposed by [credit card network] and/or any other third party provider(s), whether billed directly to Merchant by [credit card network] and/or any other third party provider(s) or through [Taxpayer].

Taxpayer's position is that the unbundled agreement builds into the transaction with each merchant the amount that the merchant owes Taxpayer, including the cost of the interchange fee, and that the unbundled agreement "clearly states that 'Merchant agrees to pay [Taxpayer] all the current fees, assessments, and penalties as imposed by [credit card network].'"

Insofar as both the "bundled" and "unbundled" agreements, Taxpayer's position is that the interchange fees here at issue "are expenses of the merchant banks and are one of the cost components that the Merchant Bank attempts to cover in setting the amount of the merchant discount fee." Taxpayer concludes that the "contractual obligation for the fees specified in the agreements runs from the merchant to [Taxpayer]."

In addition to citing to the agreements Taxpayer has with its merchants, Taxpayer also points to the credit card network regulations. In those regulations the "Merchant Bank" is referred to as the "acquirer," a designation which is supported by the secondary authorities cited above. The credit card network's agreement provides that an "acquirer" is a member of the network "that signs a Merchant or disburses currency to a Cardholder in a Cash disbursement, and directly or indirectly enters the resulting Transaction Receipt into interchange." The credit card network's regulations define the "interchange fees" as follows:

> A fee that an Acquirer pays to an Issuer in the Clearing and Settlement of an Interchange Transaction or [a] fee that an Issuer pays to an acquirer for making a Cash Disbursement to a cardholder or Cheque purchaser.

Taxpayer points to the credit card network's regulations as providing that the interchange fee "is one of the expenses incurred by the merchant bank that it must consider in setting the merchant bank" and that the "interchange fee is one of the expenses incurred by the merchant bank that it must consider in setting the merchant bank discount."

In effect, the credit card network's regulation provides that the interchange reimbursement fee is "[a] fee that an Acquirer pays to an Issuer in the Clearing and Settlement of an Interchange Transaction...." Elsewhere, the credit card network's regulations provide that "An Acquirer pays an Interchange Reimbursement Fee for each Interchange Transaction completed within the 50 United States and the District of Columbia...."

Determining the liabilities of the parties and the various costs and fees owed the participants is complicated by the nature of the parties' relationships and the fact that participants settle their liabilities daily by continuously and simultaneously offsetting the debits and credits of large numbers of participants and transactions. Nonetheless, the Department is prepared to agree that Taxpayer, for purposes of this Letter of Findings, has met its burden under IC § 6-8.1-5-1(c) of establishing that the interchange fee is one component of the amount owed by the Merchants to Taxpayer as the Merchant Bank (or Acquiring Bank) and that Taxpayer was obligated to pay those fees to the Issuing Banks. The Merchant had no obligation to pay the Issuing Bank the interchange fee and the Issuing Bank had no right to collect the interchange fee from the Merchant because the Merchant and the Issuing Bank have no direct relationship. Taxpayer was not an agent acting on behalf of the Issuing Bank in the collection of the interchange fee; the interchange fees were imposed solely on Taxpayer as a result of the relationship between Taxpayer and its merchant customers.

Taxpayer has buttressed this conclusion by supplying specific examples of instances in which Taxpayer was obligated to pay the interchange fee to the Issuing Bank even though Taxpayer never received the merchant discount from the merchant as a result of the particular Merchant's bankruptcy. Taxpayer cites to various instances in which merchant customers went bankrupt and it unilaterally paid the interchange fees to the Issuing Banks. The information tends to support Taxpayer's assertion that the interchange fee is an expense owed by Taxpayer to the Issuing Bank regardless of whether it ever collected the merchant discount from the bankrupt merchant.

For these years and for this particular financial institution, Taxpayer has established that – assuming a single hypothetical transaction – Taxpayer might owe $100 to one of its merchants in order to settle a cardholder's transaction, and the merchant might owe a corresponding $1.50 merchant discount fee to Taxpayer pursuant to the merchant agreement. The $100 obligation and the $1.50 merchant discount would be offset resulting in a net credit to the merchant of $98.50 but the merchant would be obligated to Taxpayer for the entire $1.50, the full $1.50 was owed Taxpayer, and Taxpayer was entitled to include the full $1.50 in the receipts apportionment factor pursuant to IC § 6-5.5-4-8 because "the contractual obligation for the fees specified in the agreements runs from the merchant to [Taxpayer]."

FINDING

Taxpayer's protest is sustained.

II. Combined Return – Financial Institutions Tax

DISCUSSION

Taxpayer objects to the inclusion of certain related entities in its combined returns. For Financial Institution Tax purposes, a "unitary group" files a "combined return" including the entities transacting the business of a financial institution and computes its adjusted gross income in accordance with IC § 6-5.5-2-4.

It bears repeating that, as a preliminary matter, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." In this particular question, Taxpayer must demonstrate that these entities should not have been included in the combined FIT return.

IC § 6-5.5-2-4 determines what income should be included in Taxpayer's combined return.

> For a taxpayer filing a combined return for its unitary group, the group's apportioned income for a taxable year consists of:
>
> (1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by
>
> (2) the quotient of:
>
> (A) all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by
>
> (B) the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions.

IC § 6-5.5-1-18 defines the term "unitary group" for FIT purposes.

> (a) "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless

of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana. However, the term does not include an entity that does not transact business in Indiana.

(b) Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of the unitary group, as described in subsection (a). However, the absence of these centralized activities does not necessarily evidence a nonunitary business.

(c) Unity of ownership, when a corporation is involved, does not exist unless that corporation is a member of a group of two (2) or more business entities and more than fifty percent (50[percent]) of the voting stock of each member of the group is directly or indirectly owned by:

(1) a common owner or common owners, either corporate or noncorporate; or

(2) one (1) or more of the member corporations of the group.

The issue in this section is whether the entities are or are not (1) conducting the business of a financial institution and (2) whether or not the entities are or are not conducting the business of a financial institution in Indiana.

Taxpayer disputes the audit's conclusion that "Mortgage Services," "Mortgage II," "Holdings," "Investment Trust," "Realty LLC," "Holdings Funding," and "Conduit Holdings," were conducting the business of a financial institution in Indiana.

Taxpayer explains the relationship between "Mortgage Services" and "Mortgage II." Taxpayer explains that it acquired "Mortgage Services" and that – following the acquisition – Taxpayer continued its Michigan mortgage origination business through "Mortgage II" with "Mortgage Services" becoming a "holding company with its focus being the ownership of 99 [percent] of 'Mortgage II.'"

However, Taxpayer argues that "Mortgage Services" has no tangible or real property in Indiana, that it is managed by a Michigan board of directors, that it has "no employees, representatives, or independent contractors acting on its behalf in the state of Indiana." Because it functions as a holding company, Taxpayer states that "Mortgage Services" "does not sell products or services, solicit business, perform services, or engage in transactions with customers in Indiana."

Taxpayer maintains that the commercial loans owned by "Mortgage II" were originated by another entity and that "Mortgage II" simply purchased what is characterizes as a "participation interest" in commercial loans which generated a de minimis amount of Indiana receipts. In support of that position, Taxpayer cites to IC § 6-5.5-3-8 which is considered in detail following.

Insofar as both "Mortgage II" and "Mortgage Services," Taxpayer concludes that neither entity is engaged in transactions with Indiana customers and that "[i]f one takes into consideration all of the relevant facts and the applicable statutory provisions, the only logical conclusion is that neither [Mortgage II] nor [Mortgage Services] were transacting business in Indiana."

A. Mortgage Services

The Department's audit reviewed Taxpayer's business structure and determined that income earned by "Mortgage Services" should be included in the combined return.

The audit report noted that "Mortgage Services" was included in Taxpayer's federal consolidated income tax returns but was not included in the Indiana combined FIT returns. The audit report pointed out that "Mortgage Services" owned a 99 percent interest in a partnership herein designated as "Mortgage II." On the Department's inquiry, Taxpayer noted that "Mortgage II" possessed loans with Indiana businesses in "Mortgage II's" portfolio of commercial loans.

The audit concluded that although "Mortgage II" was a partnership and not a taxpayer, its income was part of Indiana's unitary income for the combined group and that "Mortgage II's" income was subject to taxation "through the inclusion of Taxpayer's corporate partners in the combined Indiana FIT return."

As authority for that decision, the Department cited to IC § 6-5.5-2-8.

(a) If a corporation is:

(1) transacting the business of a financial institution (as defined in IC 6-5.5-1-17(d)); and

(2) is a partner in a partnership or the grantor and beneficiary of a trust transacting business in Indiana and the partnership or trust is conducting in Indiana an activity or activities that would constitute the business of a financial institution if transacted by a corporation;

the corporation is a taxpayer under this article and shall, in calculating the corporation's tax liability under this article, include in the corporation's adjusted or apportioned income the corporation's percentage of the partnership or trust adjusted gross income or apportioned income.

(b) A partnership or trust covered by subsection (a):

(1) shall file an information return on an appropriate schedule, with capital and operating losses, modifications, and credits required by this article and any other items specified in the return form by the department. If the taxpayer is a nonresident, or is a member of a unitary group with nonresident members filing a combined return, the return must show the apportionment percentage and supporting amounts

necessary to compute the tax under IC 6-5.5-4. A partner's percentage share of the receipts of a taxpayer, for the purpose of Apportionment, shall be calculated by using the partner's share of the partnership adjusted gross income;
(2) is subject to the provisions of IC 6-5.5-7-3 relating to taxpayers and IC 6-5.5-7-4 relating to persons when filing the information return; and
(3) shall withhold from all nonresident corporate partners or beneficiaries an amount prescribed in withholding instructions issued by the department. The amount required to be withheld shall be based upon the rate of tax prescribed in IC 6-5.5-2, unless the partner or beneficiary provides the partnership or trust with a written declaration that the partner or beneficiary is not subject to the tax. In such a case the amount withheld shall be the amount prescribed in the withholding instructions issued by the department based upon the Indiana adjusted gross income tax rates. The department shall issue procedures and directions for the withholding required by this subsection that are similar to those contained in IC 6-3-4 concerning the withholding of taxes. (Emphasis added).

Based on the authorities cited above, the audit concluded that Mortgage II was a "partnership" under IC § 6-5.5-2-8(a)(2) and that Mortgage Services was a "partner" under IC § 6-5.5-2-8(a)(2).

However, Taxpayer states that neither "Mortgage Services" nor "Mortgage II" is engaged in any of the activities set out in IC § 6-5.5-3-1 as set out below.

Taxpayer points to IC § 6-5.5-3-1 as setting out the factors which are necessary before a taxpayer can be defined as transacting business within Indiana:

For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:
(1) maintains an office in Indiana;
(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana. (Emphasis added).

Taxpayer indicates that the activities of "Mortgage Services" are not sufficient to allow a conclusion that "Mortgage Services" is transacting business in Indiana; Taxpayer states that "Mortgage Services" has no employees, representatives, or contractors conducting business in Indiana; "Mortgage Services" does not solicit business from Indiana customers; "Mortgage Services" does not perform services that are consumed in Indiana; "Mortgage Services" does not own or lease property located in the state; "Mortgage Services" does not solicit or receive deposits from Indiana customers.

Taxpayer complains that the Department's audit included "Mortgage Services" in the combined return based on the activities of the partnership identified here as "Mortgage II" but that doing so – based on the "mere receipt of interest income from commercial loans secured by Indiana collateral" – is not supported under Indiana law.

Taxpayer raises two separate issues. First, it maintains that Mortgage II is not transacting business within Indiana. Taxpayer thus concludes that Mortgage II has no adjusted gross income or apportioned income from Indiana, and, therefore, as a partner in Mortgage II, Mortgage Services cannot have any Indiana adjusted gross income or apportioned income either. This issue is discussed in the next section.

Second, Taxpayer maintains that even if Mortgage II was transacting business in Indiana, that fact alone would still not permit the Department to include its partner – Mortgage Services – in Taxpayer's combined return. Taxpayer states that there is nothing in IC § 6-5.5-3-1 that treats ownership of an interest in a partnership or an LLC as "transacting business" in Indiana. IC § 6-5.5-1-18 provides that an entity is not part of a unitary business if it does not transact business in Indiana. IC § 6-5.5-2-8 provides that a partner in a partnership may be taxable on its share of the partnership's income, but it does not say that the partner is transacting business in the state by virtue of being taxable on such income. According to Taxpayer, even if Mortgage Services has some taxable income from Mortgage II under IC § 6-5.5-2-8 on which it may owe tax, it cannot be pulled into the Taxpayer's combined return solely on that basis.

B. Mortgage II

Upon review, the audit concluded that "Mortgage II" was transacting the business of a financial institution because its gross income was derived from Indiana loan and mortgage receipts. Further, "Mortgage II" was engaged in transactions with Indiana residents since it reported interest from Indiana residents as income. The audit report continued:

The fact that [Taxpayer's] affiliates may originate or service the loans of [Mortgage II] does not diminish the connection of [Mortgage II] to the Indiana residents since the loans are owned by [Mortgage II] and the income is reportable by [Mortgage II].

Taxpayer explains that it acquired the parent of Mortgage Services and that – following this acquisition – it conducted its Michigan mortgage origination business through Mortgage II with Mortgage Services becoming a "holding company with its focus being the ownership of 99 [percent] of Mortgage II."

Taxpayer maintains that the commercial loans owned by "Mortgage II" were originated by another entity and that "Mortgage II" simply purchased a participation interest in certain commercial loans which were generating a de minimis amount of Indiana receipts. In support of that position, Taxpayer cites to IC § 6-5.5-3-8. Therefore, in Taxpayer's view, "Mortgage II" was not transacting business within Indiana under IC § 6-5.5-3-1(6) because, during the audit years, it did not engage in current transactions with customers in Indiana involving loans that resulted in receipts flowing to "Mortgage II" from Indiana. Taxpayer maintains that collecting interest on a loan originated by another entity is not a current year transaction triggering IC § 6-5.5-3-1(6).

Taxpayer also notes that, aside from the fact that the activities of "Mortgage II" do not satisfy the tests for transacting business under IC § 6-5.5-3-1, IC § 6-5.5-3-8(5)(C) provides a safe harbor provision that would apply:

> Notwithstanding any other provision of this chapter, a taxpayer, except for a trust company formed under IC 28-1-4, is not considered to be transacting business in Indiana if the only activities of the taxpayer in Indiana are or are in connection with any of the following:
>
> (1) Maintaining or defending an action or suit.
>
> (2) Filing, modifying, renewing, extending, or transferring a mortgage, deed of trust, or security interest.
>
> (3) Acquiring, foreclosing, or otherwise conveying property in Indiana as a result of a default under the terms of a mortgage, deed of trust, or other security instrument relating to the property.
>
> (4) Selling tangible personal property, if taxation under this article is precluded by 15 U.S.C. 381 through 384.
>
> (5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:
>
> (A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).
>
> (B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.
>
> (C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.
>
> (D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.
>
> (E) An amount held in an escrow or a trust account with respect to property described in this subdivision.
>
> (6) Acting:
>
> (A) as an executor of an estate;
>
> (B) as a trustee of a benefit plan;
>
> (C) as a trustee of an employees' pension, profit sharing, or other retirement plan;
>
> (D) as a trustee of a testamentary or inter vivos trust or corporate indenture; or
>
> (E) in any other fiduciary capacity, including holding title to real property in Indiana. (Emphasis added).

Insofar as to whether Mortgage II was conducting the business of a financial institution in Indiana, Taxpayer concludes that Mortgage II was not engaged in transactions with Indiana customers during the years under examination and therefore none of the income that "Mortgage Services" derived from "Mortgage II" was taxable.

Taxpayer points to IC § 6-5.5-3-1 as setting out the factors which are necessary before "Mortgage Services" can be classified as conducting the business of a financial institution. In particular, Taxpayer cites to IC § 6-5.5-3-1(6) which states that an entity is "transacting business within Indiana" only if the entity;

> (6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana.... (Emphasis added).

Taxpayer explains that the activities of "Mortgage Services" are not sufficient to allow a conclusion that "Mortgage Services" is transacting business in Indiana: Taxpayer states that "Mortgage Services" has no employees, representatives, or contractors conducting business in Indiana; "Mortgage Services" does not solicit business from Indiana customers; "Mortgage Services" does not perform services that are consumed in Indiana; "Mortgage Services" does not own or lease property located in the state; "Mortgage Services" does not solicit or receive deposits from Indiana customers.

Taxpayer argues that the Department's audit included "Mortgage Services" in the combined return based on the activities of its partner identified here as "Mortgage II" but that doing so, based on the "mere receipt of interest income from commercial loans secured by Indiana collateral," is not supported under Indiana law.

IC § 6-5.5-2-8(a) states:

If a corporation is:

(1) transacting the business of a financial institution (as defined in IC 6-5.5-1-17(d)); and

(2) is a partner in a partnership or the grantor and beneficiary of a trust transacting business in Indiana and the partnership or trust is conducting in Indiana an activity or activities that would constitute the business of a financial institution if transacted by a corporation;

the corporation is a taxpayer under this article and shall, in calculating the corporation's tax liability under this article, include in the corporation's adjusted or apportioned income the corporation's percentage of the partnership or trust adjusted gross income or apportioned income.

1. Mortgage Services Analysis:

In order for the Department to find that "Mortgage Services" is in the combined return, two separate statutory tests must be met under IC § 6-5.5-2-8. The first test is whether Mortgage Services is "transacting the business of a financial institution" under IC § 6-5.5-1-17(d). The audit found that Mortgage Services was "a subsidiary of a regulated financial institution, operated as a financial institution, and [that] it was a partner in a partnership that received interest income from Indiana residents which flowed through intact as a result of its partnership ownership interest." Therefore, Mortgage Services is clearly "transacting the business of a financial institution" and the first test is met.

The second test is whether Mortgage Services is a partner in a partnership that is conducting the business of a financial institution in Indiana. Once these two tests are met, the language of IC § 6-5.5-2-8(a)(1), (2) provides that the corporate partner is a taxpayer for FIT purposes. No further analysis of the corporation's activities (or lack of activities) is necessary because Mortgage Services is a partner in Mortgage II. Mortgage II is receiving interest payments from Indiana customers. The audit was correct in determining that Mortgage Services should have been included in Taxpayer's combined return.

2. Mortgage II Analysis:

The next issue is whether Mortgage II is conducting the business of a financial institution in Indiana.

IC § 6-5.5-3-1 provides:

For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:

(1) maintains an office in Indiana;

(2) has an employee, representative, or independent contractor conducting business in Indiana;

(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;

(4) regularly solicits business from potential customers in Indiana;

(5) regularly performs services outside Indiana that are consumed within Indiana;

(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;

(7) owns or leases tangible personal or real property located in Indiana; or

(8) regularly solicits and receives deposits from customers in Indiana.

Mortgage II regularly engages in transactions involving loans and receives loan interest otherwise partially attributable to Indiana. The receipt of loan interest means that Mortgage II is conducting the business of a financial institution unless **all** its loans are "properly excluded under IC § 6-5.5-3-8(5)."

IC § 6-5.5-3-8 states in relevant part:

Notwithstanding any other provision of this chapter, a taxpayer, except for a trust company formed under IC 28-1-4, is not considered to be transacting business in Indiana if the only activities of the taxpayer in Indiana are or are in connection with any of the following:

(5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:

(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).

(B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

(C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(E) An amount held in an escrow or a trust account with respect to property described in this subdivision. (Emphasis added).

Taxpayer acquired ownership of the parent of Mortgage Services and thereafter conducted its Michigan mortgage origination business though Mortgage II. Since the loans were solicited by the entity which Taxpayer acquired, Taxpayer "stepped into the shoes" of that originating entity; Taxpayer acquired the originating entity's interests, assets, benefits, and liabilities. The loans were not " solicited and entered into by a person that is independent and not acting on behalf of the owner...." IC § 6-5.5-3-8(5)(C).

The audit was correct in determining that Mortgage II was conducting the business of a financial institution in Indiana and that Mortgage II should have been included in Taxpayer's combined return.

C. Holdings.

The issue is whether "Holdings" should have been included in Taxpayer's combined return. The audit made an adjustment to include "Holdings" in the Indiana combined FIT return. The audit pointed out that "Holdings" was included by Taxpayer in the federal consolidated return but that "Holdings" was not included in the Indiana combined FIT return.

The Department's audit report describes "Holdings" as follows: "'Holdings' was a party to the automobile loan securitizations because it was an intermediate holder and seller of the loan receivables which included Indiana loans." The audit report noted that, "Information was not provided regarding whether this entity was compensated for that activity or if it sustained a gain from the intermediate sale of the receivables." Nonetheless, Taxpayer did indicate that "Holdings" held commercial auto loan portfolios on its own and that "Holdings" did receive Indiana based income.

As authority for its decision to include "Holdings" in the Indiana return, the audit cites to IC § 6-5.5-3-1 as supporting the proposition that entering into transactions with Indiana customers that involve intangible property – such as automobile loans – constitutes transacting business in this state. The audit report stated that, "The fact that [T]axpayer may contract with another party to service the loans does not negate the fact that the [T]axpayer is the owner of the loans and corresponding interest."

Taxpayer argues that the Department erred in including "Holdings" in Taxpayer's combined return. Taxpayer explains that "Holdings" was formed as a subsidiary of one of Taxpayer's out-of-state subsidiaries to "facilitate future auto loan securitizations." Taxpayer further explains that the use of "'Holdings' in the securitization process [was] beneficial in securing the desired true sale treatment for credit purposes."

Taxpayer further explains that "Holdings" is managed and operated outside the state of Indiana and that the loan portfolio that "Holdings" passively owns was originated by another entity with "Holdings" acquiring only "beneficial and equitable interests in the underlying loans."

As authority for Taxpayer's position that "Holdings" should not have been included in the combined return, Taxpayer cites to IC § 6-5.5-1-18(a) and IC § 6-5.5-3-1 and concludes that the "periodic receipt of interest income by itself is not sufficient to rise to the level of transacting business with Indiana." Taxpayer claims that during the audit years, "Holdings" did not actively engage in transactions with customers in Indiana involving loans that resulted in receipts flowing to "Holdings" from Indiana. Taxpayer maintains that collecting interest on a loan originated by another entity is not "a current year transaction triggering IC § 6-5.5-3-1(6)."

Taxpayer also cites to IC § 6-5.5-3-8(5)(C) as supporting its proposition that "the mere ownership of loans does not rise to the level of transacting business in Indiana."

Notwithstanding any other provision of this chapter, a taxpayer, except for a trust company formed under IC 28-1-4, is not considered to be transacting business in Indiana if the **only** activities of the taxpayer in Indiana are or are in connection with any of the following:

(1) Maintaining or defending an action or suit.

(2) Filing, modifying, renewing, extending, or transferring a mortgage, deed of trust, or security interest.

(3) Acquiring, foreclosing, or otherwise conveying property in Indiana as a result of a default under the terms of a mortgage, deed of trust, or other security instrument relating to the property.

(4) Selling tangible personal property, if taxation under this article is precluded by 15 U.S.C. 381 through 384.

(5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:

(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).

(B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

(C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(E) An amount held in an escrow or a trust account with respect to property described in this subdivision.

(6) Acting:

(A) as an executor of an estate;

(B) as a trustee of a benefit plan;

(C) as a trustee of an employees' pension, profit sharing, or other retirement plan;

(D) as a trustee of a testamentary or inter vivos trust or corporate indenture; or

(E) in any other fiduciary capacity, including holding title to real property in Indiana. (Emphasis added).

The first issue is whether "Holdings" was conducting the business of a financial institution in Indiana based upon the periodic receipt of interest payments attributable to the securitization of Indiana automobile loans.

The issue goes to the nature of "Holding's" securitization activities. Securitization means "To convert (assets) into negotiable securities for resale in the financial markets allowing the issuing financial institution to remove assets from its books to improve its capital ratio making new loans with the security proceeds." Black's Law Dictionary 1358 (7th ed. 1999). Based on the information contained within the audit report, one of Taxpayer's affiliates loaned money to Indiana customers. Affiliates pooled this contractual automobile loan debt into the form of "asset backed securities" and sold the "asset backed securities" in the form of a security interest to various investors including "Holdings." Insofar as the Indiana customers, the sale of the debt was irrelevant. However, "Holdings" – as an investor in the asset backed securities – received Indiana income as the debt was repaid by the Indiana customers.

The FIT is imposed on both "nonresident" and "resident taxpayers" transacting business within Indiana. IC § 6-5.5-1-12, 13. IC § 6-5.5-1-12 defines a "nonresident taxpayer" as a "taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana."

45 IAC 17-2-1 explains that the FIT is "intended to tax both traditional financial institutions that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana."

For purposes of the FIT, a corporation that is transacting the business of a financial institution, includes a regulated financial corporation, IC § 6-5.5-1-17(a)(2), any other corporation that is carrying on the business of a financial institution, IC § 6-5.5-1-17(a)(4), and specifically includes "[m]aking, acquiring, selling, or servicing loans or extensions of credit." IC § 6-5.5-1-17(d)(2)(A). The provision goes on to say that, "For the purpose of this subdivision, loans and extension of credit include (i) secured or unsecured consumer loans." Id.

Based on the information provided, "Holdings" is plainly conducting the business of a financial institution under IC § 6-5.5-1-17(d)(2)(A) because "Holdings" receives money from securitized loans. The next issue is whether "Holdings" is conducting the business of a financial institution in Indiana.

IC § 6-5.5-3-1 provides as follows:

For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:

(1) maintains an office in Indiana;

(2) has an employee, representative, or independent contractor conducting business in Indiana;

(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;

(4) regularly solicits business from potential customers in Indiana;

(5) regularly performs services outside Indiana that are consumed within Indiana;

(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;

(7) owns or leases tangible personal or real property located in Indiana; or

(8) regularly solicits and receives deposits from customers in Indiana. (Emphasis added).

IC § 6-5.5-3-1 contains a reference to IC § 6-5.5-3-8(5) which states that an entity is "not transacting business in Indiana if the only activities of the taxpayer in Indiana are or are in connection with.... owning... [a]n interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner." (Emphasis added). Taxpayer does not fall within the "safe-harbor" provision set out in IC § 6-5.5-3-8(5)(C) because receiving interest from securitized loans is not "Holdings" only Indiana activity; "Holdings" was an integral part of the original securitization transactions. In the case of "Holdings," it is receiving interest income from transactions entered into by an affiliate entity.

Based on the foregoing and under IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of demonstrating that the proposed assessment was incorrect. "Holdings" is conducting the business of a financial institution and is doing so in Indiana because it receives income from Indiana customers attributable to securitized loans originally entered into by a Taxpayer related entity. The Department must disagree that the "periodic receipt of interest income" from Indiana customers does not rise to the level of "transacting business in Indiana" but believes that the receipt of interest income from Indiana customers falls squarely within the purview of the FIT. The Department's audit correctly included "Holdings" in the combined return.

D. REITs "Investment Trust" and "Realty LLC".

The Department made an adjustment to include "Investment Trust" and "Realty LLC" in the Indiana combined FIT returns and to include their income – net of the dividends paid deduction – in the combined adjusted gross income subject to tax.

"Investment Trust" is a real estate investment trust (REIT) that owns home equity lines of credit and other real estate backed assets. "Investment Trust" is owned by Taxpayer's related entity. Yet another Taxpayer related entity, services the loans held by "Investment Trust."

"Realty LLC" is a REIT that also owns home equity lines of credit and real estate backed assets. "Realty LLC" is owned by Taxpayer's related entity. Yet another related entity services the loans held by "Realty LLC."

The audit report includes the following explanation of a "REIT."

> A REIT is a special purpose entity that would otherwise be taxed as a domestic corporation if it were not for its REIT election. REITs, by definition are required to hold real estate investments and have at least 100 beneficial owners. Unlike a regular corporate entity, REITs are allowed to deduct dividends paid to shareholders in determining taxable income. REITs are required to distribute 90[percent] of their annual taxable income to their shareholders. The allowance of the dividends paid deduction in determining taxable income and the required distribution of dividends to the shareholders results in the REIT being a pass-through entity, in that the tax liability for the income is passed through to the shareholders.

The audit found that Taxpayer was required to include in the combined return the adjusted gross income of all members of the unitary group that "transact business" in Indiana. According to the audit, both "Investment Trust" and "Realty LLC" own loans in which the borrowers are Indiana residents and that these loans are secured by property located in Indiana. As authority for the decision that both "Investment Trust" and "Realty LLC" were required to include their income in the combined return, the audit pointed to IC § 6-5.5-3-1 which states:

> For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:
>
> (1) maintains an office in Indiana;
>
> (2) has an employee, representative, or independent contractor conducting business in Indiana;
>
> (3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
>
> (4) regularly solicits business from potential customers in Indiana;
>
> (5) regularly performs services outside Indiana that are consumed within Indiana;
>
> (6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
>
> (7) owns or leases tangible personal or real property located in Indiana; or
>
> (8) regularly solicits and receives deposits from customers in Indiana. (Emphasis added).

REITs are allowed the "dividends paid deduction" in determining their taxable income. Dividends paid by "Investment Trust" and "Realty LLC" to other Taxpayer related entities included in the Indiana combined return were reported. The audit's adjustment to include "Investment Trust" and "Realty LLC" had no tax effect in determining the federal adjusted gross income of the combined group. However, the inclusion of "Investment Trust" and "Realty LLC" did have apportionment implications for Indiana FIT purposes.

Taxpayer maintains that under IC § 6-5.5-1-18(a), the two REITs can only be included in the combined returns if "Investment Trust" and "Realty LLC" are transacting business in Indiana. IC § 6-5.5-1-18(a) states:

> "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana. However, the term does not include an entity that does not transact business in Indiana.

Because Taxpayer maintains that "Investment Trust" and "Realty LLC" are not transacting business in Indiana, Taxpayer argues that the two REITs cannot be included in the combined return because the REITs' activity is limited to the passive receipt of interest income from the REITs' loan portfolio.

Taxpayer points to IC § 6-5.5-3-1 as setting out the prerequisites necessary before requiring that the REITs be included in the combined FIT return and concludes that the "activities of the REITs are not sufficient to conclude that either entity is transacting business in Indiana and that the "periodic receipt of interest income by itself is not sufficient to rise to the level of transacting business with Indiana." Taxpayer claims that during the audit years, "Investment Trust" and "Realty LLC" did not engage in transactions with customers in Indiana involving loans that resulted in receipts flowing to these entities from Indiana and that the REITs' loans were originated by another entity. Taxpayer maintains that collecting interest on a loan originated by another entity is not "a current year transaction triggering IC § 6-5.5-3-1(6)."

As further support for its argument, Taxpayer points to IC § 6-5.5-3-8 as standing for its proposition that merely holding ownership of loans does not rise to the requisite level of "transacting business" in Indiana.

The question is simply one of "apportionment" because the REITs were allowed the "dividends paid deducting in determining their taxable income." As noted in the audit report, the inclusion of the two REITs "does have apportionment implications...." The issue is whether the two REITs should be included in the combined return.

The first issue is whether "Investment Trust" and "Realty LLC" were conducting the business of a financial institution based upon the fact that the REITs were collecting interest from Indiana customers attributable to "home equity lines of credit" and certain "real estate backed assets." The second issue is whether "Investment Trust" and "Realty LLC" are conducting the business of a financial institution in Indiana.

As noted previously, the FIT is imposed on both "nonresident" and "resident taxpayers" transacting business within Indiana. IC § 6-5.5-1-12, 13. IC § 6-5.5-1-12 defines a "nonresident taxpayer" as a "taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana." For purposes of the FIT, a corporation that is transacting the business of a financial institution, includes a regulated financial corporation, IC § 6-5.5-1-17(a)(2), any other corporation that is carrying on the business of a financial institution, IC § 6-5.5-1-17(a)(4), or a "subsidiary of either." The provision specifically includes "[m]aking, acquiring, selling, or servicing loans or extensions of credit." IC § 6-5.5-1-17(d)(2)(A). The provision goes on to say that, "For the purpose of this subdivision, loans and extension of credit include... (iii) mortgage or other secured loans on real estate or tangible personal property." Id.

Based on the information provided, both "Investment Trust" and "Realty LLC" are plainly conducting the business of a financial institution because they are receiving interest income attributable to real estate backed loans and other home equity loans.

As to the question of whether "Investment Trust" and "Realty LLC" are conducting the business of a financial institution in Indiana, IC § 6-5.5-3-1(6) provides that "a taxpayer is transacting business within Indiana in taxable year only if the taxpayer.... regularly engages in transactions with customers in Indiana that involve intangible property including loans, but not property described in section 8(5) of this chapter and result in receipts flowing to the taxpayer from within Indiana."

The real estate backed loans were originated by Taxpayer's related entities. "Investment Trust" and "Realty LLC" were not "strangers to the transaction" and are not passive investors with any ties to the original loan transactions. The two REITs earn money attributable to loans originated by related entities which are included in the Taxpayer's combined return. Investment Trust's loans are "serviced" by one of Taxpayer's related entities. The assertion that the two REITs are not "transacting business in Indiana" is unsupported. IC § 6-5.5-1-18(a) requires that the two REITs be included in the combined return because, "The term 'unitary group' includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana."

E. "Holdings Funding" and "Conduit Holdings."

The audit included "Holdings Funding" and "Conduit Holdings" in the combined return. Taxpayer disagrees stating that "Holdings Funding" and "Conduit Holdings" should not have been included in the return.

The audit included the income of "Holdings Funding" and "Conduit Holdings" noting that Taxpayer included both entities in its federal consolidated income tax return but not the Indiana combined FIT return. The audit found that these entities had "[i]nterest income included in the federal taxable income... sourced from securitized loan portfolios that have included loans made to Indiana residents."

1. "Holdings Funding."

The audit report described the securitization process involving "Holdings Funding" as follows. Taxpayer related entities – known as "originators" – purchased motor vehicle loans from automobile dealers throughout the country. The loan receivables were then sold by the related entity originators to yet another related entity known as "Holdings." In this series of transactions, "Holdings" is known as the "Seller." "Holdings" then sold the receivables to "Holdings Funding" known as the "Depositor." "Holdings Funding" then sold the receivables to the issuing entity known here as "Trust." Issues related to "Holdings" are addressed in Part "C" above.

"Holdings Funding" also held ownership in certificates that were issued by "Trust." Another of Taxpayer's related entities thereafter serviced the loans.

Included in the securitized loans were loans made to Indiana residents. Interest income received from these loans was reportable to "Trust." As a grantor trust, the income of "Trust" was included in the income of "Holdings

Funding."

The audit report concluded as follows:

[Holdings Funding] was receiving income from loans secured by property located in Indiana by Indiana borrowers. [Holdings Funding] was transacting the business of a financial institution in Indiana by engaging in financial transactions with Indiana customers. The fact that it contracted with related parties to service the loans does not negate the fact that it was the holder of the receivables and the owner of the income.

2. "Conduit Holdings."

Taxpayer describes the securitization process involving "Conduit Holdings" as follows: Two of Taxpayer's entities known as "Originators" purchased motor vehicle loans from various dealers throughout the country. These receivables were then sold by the originator to "Holdings" known as the "Seller." "Holdings" then sold the receivables to "Conduit Holdings." "Conduit Holdings" was known as the "Borrower." "Conduit Holdings" entered into an agreement with third party conduits to borrow [$1.9 billion] secured by the automobile loan receivables. "Conduit Holdings" continued to own the loan receivables.

The audit found that "Conduit Holdings" was included in Taxpayer's federal consolidated tax return but was not included in the Indiana combined FIT tax return. Included in the loan receivables used as security by "Conduit Holdings," were loans secured by Indiana property or loans made to Indiana residents. In effect, the audit found that "Conduit Holdings" was receiving interest income from Indiana residents and "Conduit Holdings" was transacting the business of an Indiana financial institution. The audit concluded that, "The fact that ["Conduit Holdings"] contracted with related parties to service the loans does not negate the fact that ["Conduit Holdings"] was the holder of the receivables and owner of the income."

Taxpayer explains as follows that these two entities – "Holdings Funding" and "Conduit Holdings" – were necessary to obtain a desired "true-sale" characterization for bankruptcy purposes. As Taxpayer explains:

In order to create an entity that is remote from a bankruptcy standpoint, it is necessary for two entities to be involved in the securitization. The end result is that the entity that issues debt to third parties would stand on it[s] own in the event of receivership or bankruptcy of ["Holdings"]. Following the loan securitization these entities hold interests in the entities that issued notes to (or borrowed from) third parties.

Taxpayer further objects arguing that "Holdings Funding" was managed and operated outside Indiana. The auto loans that "Holdings Funding" passively owns were originated in the name of another entity with "Holdings Funding" simply "acquiring beneficial and equitable interests in the underlying loans.

Taxpayer maintains that under IC § 6-5.5-1-18(a), "Holdings Funding" and "Conduit Holdings" can only be included in the combined returns if "Holdings Funding" and "Conduit Holdings" are transacting business in Indiana. Because Taxpayer concludes that "Holdings Funding" and "Conduit Holdings" are not transacting business in Indiana, they cannot be included in the combined return.

Taxpayer points to IC § 6-5.5-3-1 as setting out the factors which are necessary before "Holdings Funding" and "Conduit Holdings" can be classified as conducting the business of a financial institution.

For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:

(1) maintains an office in Indiana;
(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana.

Taxpayer argues that "Holdings Funding" and "Conduit Holdings" conduct none of the activities set out in IC § 6-5.5-3-1 and that the "periodic receipt of interest income by itself is not sufficient to rise to the level of transacting business with Indiana." Taxpayer claims that during the audit years, "Holdings Funding" and "Conduit Holdings" did not engage in transactions with customers in Indiana involving loans that resulted in receipts flowing to these entities from Indiana. Taxpayer maintains that collecting interest on a loan originated by another entity is not a "current year transaction triggering IC § 6-5.5-3-1(6)."

Taxpayer also indicates that the loans owned by "Holdings Funding" and "Conduit Holdings" were originated by another entity and that Indiana law specifically recognizes that "mere ownership" of loans does not rise to the level of transacting business in Indiana. Specifically, Taxpayer again points to IC § 6-5.5-3-8 which functions as an "exclusionary" provision defining which entities and under which circumstances are not transacting business in this state.

Notwithstanding any other provision of this chapter, a taxpayer, except for a trust company formed under IC 28-1-4, is not considered to be transacting business in Indiana if the only activities of the taxpayer in Indiana

are or are in connection with any of the following:
(1) Maintaining or defending an action or suit.
(2) Filing, modifying, renewing, extending, or transferring a mortgage, deed of trust, or security interest.
(3) Acquiring, foreclosing, or otherwise conveying property in Indiana as a result of a default under the terms of a mortgage, deed of trust, or other security instrument relating to the property.
(4) Selling tangible personal property, if taxation under this article is precluded by 15 U.S.C. 381 through 384.
(5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:
(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).
(B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.
(C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.
(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.
(E) An amount held in an escrow or a trust account with respect to property described in this subdivision.
(6) Acting:
(A) as an executor of an estate;
(B) as a trustee of a benefit plan;
(C) as a trustee of an employees' pension, profit sharing, or other retirement plan;
(D) as a trustee of a testamentary or inter vivos trust or corporate indenture; or
(E) in any other fiduciary capacity, including holding title to real property in Indiana. (Emphasis added).

On the first question, the threshold issue is which entities are transferring the auto loans to Holdings Funding. In other words, how does Holdings Funding obtain its loans? If Holdings Funding can establish that all of the Indiana loans were originated by and obtained from unrelated entities then IC § 6-5.5-3-8(5)(C) governs and Holdings Funding is not transacting business in Indiana. However, if the loans are simply being transferred from one Taxpayer related entity to another Taxpayer related entity, IC § 6-5.5-3-8 does not govern.

If Taxpayer can show that all the loans are transferred from unrelated issuers (e.g., independent bank, unrelated car dealership), then Taxpayer's legal argument is tenable. However, if the loans are merely being transferred from one Taxpayer related entity to Holdings Funding, then the argument fails.

Taxpayer's argument, standing alone, is that the mere transfer of a loan from Entity A to Entity B does not make Entity B taxable regardless of Entity A and Entity B's relationship. However, IC 6-5.5-3-1(6) treats the receipt of loan interest as "doing business in Indiana" for FIT purposes. IC 6-5.5-3-8(5)(C) requires a further analysis of whether the soliciting party is "independent and not acting on behalf of" the relevant company.

In this case, Taxpayer has not provided sufficient information to conclude the loan issuers were "independent and not acting on behalf of" the Holdings Funding and/or Conduit Holdings, as is their duty under IC 6-8.1-5-1(c). Holdings Funding and Conduit Holdings acquired an interest in loans from a related entity including loans made to Indiana customers, secured by Indiana property, and from which Holdings Funding and Conduit Holdings derive interest income from Indiana customers. As such, Holdings Funding and Conduit Holdings were transacting the business of a financial institution under IC § 6-5.5-3-1 and are conducting the business of a financial institution in Indiana under IC § 6-5.5-3-8.

Taxpayer additionally maintains that, notwithstanding its legal position as outlined above, the audit improperly calculated the numerator of the apportionment factor. The audit report lists the numerator adjustment for Conduit Holdings as $5,948,078. Taxpayer states that, "[I]f audit report's position is determined to be the correct position... the correct amount of the alleged adjustment to the numerator is $5,649,642." Taxpayer further explains that if it "prevails on its position that Conduit Holdings is not transacting the business of a financial institution in Indiana, the [audit's] error in calculating the addition to the numerator is a moot point." The audit division is requested to review the calculation of the numerator.

FINDING

As to the substantive issue of whether Mortgage II, Mortgage Services, Holdings, Investment Trust, Realty LLC, Holdings Funding, and Conduit Holdings should have been included in the combined return, Taxpayer's protest is respectfully denied. As to the purported calculation error mentioned in this section of the Letter of Findings, the audit/enforcement division is requested to review the calculation and to make whatever adjustment it finds correct.

III. Apportionment Methodology – Financial Institutions Tax

DISCUSSION

Taxpayer sets out a secondary argument on the ground that even if "Mortgage II" – as identified in Part II above – was transacting the business of a financial institution and that "Mortgage Services" was taxable on a share of "Mortgage II's" income, that the amount of Mortgage II's taxable income must be computed based on a "post-apportionment" basis.

Taxpayer was asked to explain its "post-apportionment" methodology and did so in the scenarios marked A, B, C, and D below explaining its own methodology and explaining what it believes is the Department's incorrect methodology. Taxpayer's "post-apportionment" methodology is based on IC § 6-5.5-2-8. Taxpayer explains that this statutory provision:

> [P]rovides that a corporate partner in a partnership transacting the business of a financial institution must include in its "adjusted or apportioned income the corporation's percentage of the partnership... adjusted gross income or apportioned income."

Taxpayer relies on the legislative history of IC § 6-5.5-2-8 to support is position that the amount of Mortgage II's income taxable to Mortgage Services is its share of Mortgage II's "apportioned income," i.e. Mortgage II's income after being apportioned by the application of the apportionment formula at the entity level. Taxpayer refers to this calculation as the "post-apportionment method."

Taxpayer's position on the "post-apportionment" or "separate apportionment" methodology is explained in Taxpayer's own words as follows:

A. Taxpayer's Post-Apportionment Scenario One: Assume three different corporations, "A," "B," and "C", are members of a "unitary" group. "A" and "C" are also equal 50 percent partners in "D", which is taxed as a partnership for federal income tax purposes.

Entity "A" has $100 in overall (or "everywhere") receipts, $50 in Indiana receipts, and $10 in federal adjusted gross income;

Entity "B" has $100 in overall receipts, $30 in Indiana receipts, and $20 in federal adjusted gross income;

Entity "C" has $100 in overall receipts, $20 in Indiana receipts, and $30 in federal adjusted gross income (without regard to its share of receipts and income from partnership "D");

Partnership "D" has $100 in overall receipts, $20 in Indiana receipts, and $40 in federal adjusted gross income.

In Taxpayer's "post-apportionment" or "separate methodology", the following steps are employed:

Add the Indiana receipts of entities "A", "B", and "C" (50+30+20=100);

Add the overall receipts of entities "A", "B", and "C" (100+100+100=300);

The first apportionment percentage is calculated as 100 divided by 300 (100/300) = 33-1/3 percent;

33-1/3 percent of the adjusted gross income of "A", "B", and "C" is $20 (33-1/3 percent x (10+20+30) = 20));

The apportioned income of partnership "D" is (20/100) x 40 = $8;

"A"s distributive share of the apportioned income of "D" is $4;

"C"s distributive share of the apportioned income of "D" is $4;

After this two-step apportionment, entity "A," "B," and "C's" Indiana income is determined by adding the results of the initial calculation and the partnership calculation. $20 + $4 + $4 = $28.

B. Department's Pre Apportionment Scenario One: The Department's "pre" or "combined apportionment" methodology using the same entities cited above in Part A is as follows:

Add 50 percent of "D"s federal adjusted gross income, Indiana receipts, and overall receipts to the federal adjusted gross income, Indiana receipts, and overall receipts of its partners "A" and "C", respectively

- "A" federal adjusted gross income (10 + 20 = 30)
- "C" federal adjusted gross income (30 + 20 = 50)
- "A" Indiana receipts (50 + 10 = 60)
- "C" Indiana receipts (20 + 10 = 30)
- "A" overall receipts (100 + 50 = 150)
- "C" overall receipts (100 + 50 = 150);

Add the revised federal adjusted gross income of entities "A," "B," "C" (30+20+50 = 100);

Add the revised Indiana receipts of entities "A," "B," "C" (60+30+30=120);

Add the revised overall receipts of entities "A," "B," "C" (150+100+150=400);

Divide Indiana receipts by overall receipts (120/400) = 30 percent

30 percent of total federal adjusted gross ($100) income is $30 in Indiana income.

C. Taxpayer's Post-apportionment Scenario Two: Assume the same facts as the preceding example except that "C" is not a member of the same unitary group as "A" and "B" and does not transact business in Indiana. Taxpayer's post-apportionment methodology is as follows:

Add the Indiana receipts of entities "A" and "B" (50 + 30 = 80);

Add the overall receipts of entities "A" and "B" (100 + 100 = 200);
The first apportionment percentage is calculated as 80 divided by 200 (80/200) = 40%;
40 percent of the adjusted gross income of "A" and "B" is $12 = (40 percent x (10 + 20));
The apportioned income of partnership "D" is (20/100) x 40 = $8;
"A"s distributive share of the apportioned income of "D" is $4;
"A" and "B"s Indiana income is determined by adding the results of the initial calculation and the partnership calculation. $12 + $4 = $16;
Under IC § 6-5.5-2-8 "C" is taxable on its distributive share of "D"s income apportioned to Indiana. 50 percent x $8 = $4.

D. Department's Pre-Apportionment Scenario Two: [According to Taxpayer] The Department's "pre-apportionment" methodology applied to the same facts, as in Part C above, is as follows:

Add 50 percent of "D"s federal adjusted gross income, Indiana receipts, and overall receipts to "A"s federal adjusted gross income, Indiana receipts, and overall receipts
- "A" federal adjusted gross income (10 + 20 = 30)
- "A" Indiana receipts (50 + 10 = 60)
- "A" Indiana receipts (100 + 50 = 150);

Add the revised adjusted gross income of "A" and "B" (30 + 20 = 50);
Add the revised Indiana receipts of "A" and "B" (60 + 30 = 90);
Add the revised overall receipts of "A" and "B" (150 + 100 = 250);
Divide Indiana receipts by overall receipts (90/250) = 36 percent;
36 percent of total federal adjusted gross income ($50) is $18 in Indiana income for the unitary group.
Under IC § 6-2.5-2-8 the pre-apportionment method is applied to "C" as follows;
Add 50 percent of "D"s federal adjusted gross income, Indiana receipts, and overall receipts to "C"s federal adjusted gross income, Indiana receipts, and overall receipts
- "C" federal adjusted gross income (30 + 20 = 50)
- "C" Indiana receipts (0 + 10 = 10)
- "C" Overall receipts (100 + 50 = 150);

Divide Indiana receipts of "C" by overall receipts (10/150) = 6.67 percent;
6.67 percent of "C"s total federal adjusted gross income ($50) is $3.33 in Indiana income.

Taxpayer's explanation as to its own position and as to what it believes is the Department's position concludes with the immediately preceding line. As the outset, the Department must object in part to Taxpayer's lengthy explanation because Taxpayer's examples C and D address scenarios in which one of the corporate partners does not have Indiana receipts other than the Indiana receipts attributed to it through its ownership in partnership entity D. The cited examples also indicate that entity C was not unitary with the group while the Department's audit position argued that all corporate entities addressed in the audit were part of the unitary group. Example C illustrates an apportionment calculation where corporate partner C is only included in the Financial Institution Tax return to the extent of its share of the apportioned partnership income of entity D. The Department disagrees with the posited example because the Department finds nothing in the statute which would support anything less than the inclusion of all of C's income in the return. Anything less contravenes the unitary principle which is the basis for the combined FIT return.

There is nothing in the audit which suggests that Scenario D represents the Department's position as set out in the audit report.

The Department finds Taxpayer's explanation needlessly complicated and that its explanation – at least in part – does not represent the Department's position on the "pre" and "post-apportionment" issue. Taxpayer relies on the legislative history of IC § 6-5.5-2-8 to support its position that the amount of Mortgage II's income taxable to Mortgage Services is its share of Mortgage II's "apportioned income," i.e. Mortgage II's income after being apportioned by the application of the apportionment formula at the entity level. As noted above, Taxpayer refers to this calculation as the "post-apportionment method."

As opposed to Taxpayer's somewhat more lengthy explanation, The Department interprets Taxpayer's "post-apportionment" or "separate apportionment" methodology as follows:

Assume three different entities, "A," "B," and "C" as members of a "unitary" group.
Entity "A" has $100 in overall (or "everywhere") receipts, $50 in Indiana receipts, and $10 in federal adjusted gross income;
Entity "B" has $100 in overall receipts, $30 in Indiana receipts, and $20 in federal adjusted gross income;
Entity "C's" portion of the income and receipts from a partnership is $100 in overall receipts, $20 in Indiana receipts, and $30 in federal adjusted gross income;

In Taxpayer's "post-apportionment" or "separate methodology", the following steps are employed;
Add the Indiana receipts of entities "A" and "B" (50+30=80);
Add the overall receipts of entities "A" and "B" (100+100=200);
The first apportionment amount is calculated as (80 divided by 200 (80/200)) = 40 percent;
40 percent of entity "A" and "B's" adjusted gross income is $12 (.40 x (10+20)=12);

Entity "C's" apportionment ratio is calculated separately; (20 divided by 100 (20/100) = 20 percent;
20 percent of entity "C's" federal adjusted gross income is $6 (.20 x 30);
After this two-step "double apportionment," Entity "A," "B," and "C's" Indiana income is determined by adding the results of the two initial calculations. $12 + $6 = $18.

The Department's "pre-apportionment" or "combined apportionment" methodology using the same three entities cited above is as follows:

Add the federal adjusted gross income of entities "A," "B," "C" (10+20+30=60);
Add the Indiana receipts of entities "A," "B," "C" (50+30+20=100);
Add the overall receipts of entities "A," "B," "C" (100+100+100=300);
Divide Indiana receipts by overall receipts (100/300) = 33 percent;
33 percent of total federal adjusted gross ($60) income is $20 in Indiana income.

As noted previously, the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The FIT is imposed on taxpayers transacting the business of a financial institution within this state. IC § 6-5.5-2-1. 45 IAC 17-2-1 explains that the FIT "is intended to tax both traditional financial institutions that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana."

IC § 6-5.5-2-1 states in part:

(a) There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana. The amount of the tax for a taxable year shall be determined by multiplying eight and one-half percent (8.5[percent]) times the remainder of:

(1) the taxpayer's apportioned income; minus
(2) the taxpayer's deductible Indiana net operating losses as determined under this section; minus
(3) the taxpayer's net capital losses minus the taxpayer's net capital gains computed under the Internal Revenue Code for each taxable year or part of a taxable year beginning after December 31, 1989, multiplied by the apportionment percentage applicable to the taxpayer under IC 6-5.5-2 for the taxable year of the loss.

IC § 6-5.5-2-3 deals with the apportioned income of a taxpayer not filing a combined return:

For a taxpayer that is not filing a combined return, the taxpayer's apportioned income consists of the taxpayer's adjusted gross income for that year multiplied by the quotient of:

(1) the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by
(2) the taxpayer's total receipts from transacting business in all taxing jurisdictions, as determined under IC 6-5.5-4.

IC § 6-5.5-2-4 deals with the apportioned income of a taxpayer filing a combined return for its unitary group:

For a taxpayer filing a combined return for its unitary group, the group's apportioned income for a taxable year consists of:

(1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by
(2) the quotient of:
(A) all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by
(B) the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions. (Emphasis added).

Taxpayer has protested the Department's "combined-apportionment" method of determining its Indiana income subject to the FIT. Taxpayer contended Mortgage II's income, because it files as a partnership, should have been first apportioned between Indiana receipts and its total receipts - using a factor apportionment calculation with only the resulting Indiana apportioned receipts then included in the combined factor apportionment calculation on Taxpayer's Indiana combined return. Taxpayer apparently bases its "post-apportionment" or "separate apportionment" methodology on the phrase "adjusted or apportioned income" in IC § 6-5.5-2-8, which states:

If a corporation is:

(1) transacting the business of a financial institution (as defined in IC 6-5.5-1-17(d); and
(2) is a partner in a partnership or the grantor and beneficiary of a trust transacting business in Indiana and the partnership or trust is conducting in Indiana an activity or activities that would constitute the business of a financial institution if transacted by a corporation;

the corporation is a taxpayer under this article and shall, in calculating the corporation's tax liability include in the corporation's adjusted or apportioned income the corporation's percentage of the partnership or trust adjusted gross income or apportioned income. (Emphasis added).

The Department's audit report states that since Taxpayer is filing a combined return on behalf of its unitary group and Mortgage II is a member of the unitary group, IC § 6-5.5-2-4 clearly requires that Mortgage II's adjusted gross income must be included on the combined return - "the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group" - with a combined apportionment percentage then applied to the entire unitary group. IC § 6-5.5-2-4 provides no exceptions or qualifications.

Taxpayer points to IC § 6-5.5-2-8 which, as cited above, states that Taxpayer is to use either the adjusted or apportioned income. Taxpayer's interpretation of the statute is that the corporate partner must include the apportioned – never the adjusted gross – income in the combined return.

Taxpayer's position is that the distinction between entities that must use the adjusted gross and those that must apportion first was based on the differing treatment of a superseded provision of the FIT governing resident and non-resident entities. Prior to its amendment in 1999, FIT law required a resident entity to report all of its adjusted gross income on the return regardless of source, whereas it only required a non-resident entity to report its apportioned income on the return.

The statute may appear ambiguous on the issue of whether Taxpayer and the Department are to use a "combined" or "single" method of apportionment. To determine the correct statutory construction, the law requires consideration of the legislature's intent. Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 632 (Ind. Tax Ct. 1999). In so doing, each provision of the FIT must be reviewed in context in order to assure that the interpretation of the statutory scheme is logical and the interpretation will not bring about an absurd result. State ex rel. Hatcher v. Lake Super. Ct., Room Three, 500 N.E.2d 737, 739 (Ind. 1986). In general, the best evidence of the legislature's intent is found in the language chosen by the General Assembly. See Associated Ins. Cos., Inc. v. Indiana Dep't of State Revenue, 655 N.E.2d 1271, 1273 (Ind. Tax Ct. 1995), However, the legislative intent as ascertained from an act or statutory scheme as a whole will prevail over a strict literal reading of any one particular statutory provision. See Department of State Revenue v. Estate of Hardy, 703 N.E.2d 705,710 (Ind. Tax Ct. 1998) (citing State Natural Resources Comm'n v. AMAX Coal Co., 638 N.E.2d 418,429 (Ind. 1994).

The statutory scheme that applied to Taxpayer during the years at issue states the following. The members of the unitary group include any and all entities engaged in the unitary financial institution's business. IC § 6-5.5-1-18. The unitary group must file a combined return that includes all the operations of the unitary business and includes all the members of the unitary group. IC § 6-5.5-5-1. Each combined return must include the adjusted gross income of all the members of the unitary group, even if some of the members would not otherwise be subject to taxation under this article. IC § 6-5.5-5-2. The apportioned income for the entire unitary group is the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group multiplied by the Indiana apportionment percentage. IC § 6-5.5-2-4. This last statute was specifically amended by P.L. 68-1991 (effective January 1, 1992) to assure that the adjusted gross income rather than the apportioned income of both resident and non-resident taxpayers is included in the combined return if a taxpayer was a member of a unitary group.

IC § 6-5.5-2-8 is part of this statutory scheme. Since partnerships are pass through entities, IC § 6-5.5-2-8 specifically addresses when a corporate partner in a partnership is subject to FIT and how it is to calculate its FIT liability. The statute's reference to "adjusted gross or apportioned" income merely reflects the requirements of IC § 6-5.5-2-3 and IC § 6-5.5-2-4 and takes into consideration whether the entity is filing separately or is included in a combined return.

Taxpayer's reading of IC § 6-5.5-2-8 renders all references to "adjusted gross income" in the statute a nullity. Further, Taxpayer's reading of IC § 6-5.5-2-8 in isolation from the rest of the FIT statutory scheme contravenes the legislature's intent expressed clearly in the overarching statutory scheme as evidenced by, but not limited to, the following statutes:

(1) IC § 6-5.5-1-18 defines the unitary group to include any entity engaged in a unitary business transacted wholly or partially within Indiana. Specifically included by reference is any entity, regardless of form, that conducts activities that would constitute the business of a financial institution if the activities were conducted by a corporation;

(2) IC § 6-5.5-5-1 which requires a unitary group to file a combined return that covers all operations of the unitary business and includes all members of the unitary group;

(3) IC § 6-5.5-5-2 which provides that a combined return must include the adjusted gross income of all members of the unitary group, even if some of the members would not otherwise be subject to taxation under the FIT article; and

(4) as discussed above, IC § 6-5.5-2-4 which defines the apportioned income for a unitary group as the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group multiplied by the Indiana apportionment percentage.

Lastly, the FIT statutory scheme does not, nor has it ever, allowed the inclusion of the apportioned income of a member of a unitary group in the combined return irrespective of whether the member was a resident or non-resident, or whether the entity was a partnership or some other corporate form.

The statutory scheme requires that the adjusted gross income and receipts of the limited liability company be added to Taxpayer's adjusted gross income and receipts. After this addition, the Taxpayer's adjusted gross income tax figure is multiplied by the appropriate percentage to determine Taxpayer's Indiana adjusted gross income that is to be included in Taxpayer's combined return. This is the combined apportionment method used by the Department in determining Taxpayer's proper financial institutions tax liability. Taxpayer's stance to the contrary is at variance with the law, the intent of the law, and with the Department's previous rulings. See Letter of Findings 18-20091022 (June 25, 2010), 20100901 Ind. Reg. 045100539NRA; Letter of Findings 18-20070618 (September 29, 2008), 20081126 Ind. Reg. 045080875NRA; Letter of Findings 18-20070206 (September 11, 2007), 20071205 Ind. Reg. 045070815NRA.

The Department properly used the combined apportionment method in determining the Mortgage II's Indiana adjusted gross income to be included in Taxpayer's combined FIT return.

FINDING

Taxpayer's protest is respectfully denied.

IV. Combined Return – Financial Institutions Tax

DISCUSSION

Taxpayer indicates that "Development Corporation" was not included in its originally filed FIT returns. Taxpayer further indicates that during the course of the audit review, information was provided advising the Department that Development Corporation was transacting the business of a financial institution in Indiana and that Development Corporation should be included in the combined return. Taxpayer explains that, based on the approach that the audit was taking, Development Corporation should have been included in the combined return using the standards that the audit was proposing to apply in determining whether certain other entities should have been included in the return. Taxpayer states that, "However the Department failed to include [Development Corporation] in the return."

Taxpayer explains the Development Corporation was established to promote "affordable housing and economic development... through the use of various investments, financing alternatives and real estate lending." According to Taxpayer, these various investments permit Taxpayer to meet the requirements of the federal "Community Reinvestment Act" which requires a periodic evaluation of each depository institution's recording in meeting "the credit needs of its entire community...." Taxpayer points to the "Low-Income Housing Tax Credit" program which was established by the "Tax Reform Act of 1986" to create "market incentives for the acquisition and development or rehabilitation of affordable rental housing."

As support for its position that Development Corporation should be included in the combined return, Taxpayer cites to IC § 6-5.5-2-1(a) which states in part:

> There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana.

As further support for its position, Taxpayer cites to IC § 6-5.5-1-18(a) which – according to Taxpayer – determines what income is included in a combined FIT return.

> "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana. However, the term does not include an entity that does not transact business in Indiana.

Taxpayer asserts that Development Corporation is conducting of a financial institution by virtue of the fact that it is a subsidiary of "Financial." Taxpayer explains that "Financial" is a holding company as defined in IC § 6-5.5-1-17(b). That portion of the FIT law states:

> As used in this section, "holding company" means a corporation registered under the Bank Holding Company Act of 1956 (12 U.S.C. 1841 through 1849), as in effect on December 31, 1990, or registered as a savings and loan holding company other than a diversified savings and loan holding company (as defined in Section 10(a)(F) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1467a(1)(F)), as in effect on December 31, 1990).

Taxpayer states the Development Corporation's business activities include "originating and servicing loans with Indiana unrelated customers." Taxpayer complains that it provided the Department's representative with "apportionment and taxable income data needed to include [Development Corporation] in the combined group for the Taxable Years."

Taxpayer states that whether or not Development Corporation should have been included in the combined return was addressed "but not completely vetted" during the Department's audit. The audit concluded that Taxpayer had not provided sufficient information to include Development Corporation in the return, but Taxpayer argues that the "audit was completed without a comprehensive review of the inclusion of Development Corporation...."

> Taxpayer states that:
>
> Development Corporation invested in partnerships that provided low income housing and that some of those partnerships owned low income housing projects in Indiana. During the audit years, Development Corporation also held seven loans which had been made to unrelated entities in Indiana. The loans generated $479,552 in interest in 2006 and over $1,000,000 in 2007 and 2008 respectively. One of the loans was made in 2006, three in 2007, and one in 2008.

In connection with other issues discussed above, Taxpayer has argued that holding an interest in a partnership is not sufficient to cause a partner to be treated as transacting business in Indiana even if the partnership itself is transacting business in Indiana. Taxpayer has also argued that receiving interest in the current year from loans originated in an earlier year is not transacting business in Indiana in the current year under IC § 6-5.5-3-1(6) and that making a handful of loans in a particular year does not rise to the level of "regularly" making loans as required by IC § 6-5.5-3-1(6). Taxpayer states that if for any reason the Department rejects these arguments, then consistency would require inclusion of Development Corporation in Taxpayer's combined return.

As noted in the issues addressed above, Taxpayer has argued that merely holding an interest in a partnership is not enough to cause a partner to be treated as transacting business in Indiana even if the partnership itself is transacting business in Indiana. Taxpayer states:

> [R]eceiving interest in the current year from loans originated in an earlier year is not transacting business in Indiana in the current year under IC § 6-5.5-3-1(6) and that making a handful of loans in a particular year does not rise to the level of "regularly" making loans as required under IC § 6-5.5-3-1(6)... [I]f for any reason the Department rejects these arguments, then consistency would require inclusion of Development Corporation in Taxpayer's combined return.

Taxpayer concludes that Development Corporation was transacting the business of an Indiana financial institution and asks that an adjustment be made to include Development Corporation in the combined return.

In this particular instance, the Department is prepared to agree that the issue should be revisited by the audit/enforcement division. Based upon the information presented prior to and during the administrative hearing, under IC § 6-5.5-1-17(b), Development Corporation was apparently "conducting the business of a financial institution." Under IC § 6-5.5-1-17(b)(1), the "business of a financial institution" includes:

> For a holding company, a regulated financial corporation, or a subsidiary of either, the activities that each is authorized to perform under federal or state law....

Development Corporation is a financial institution "transacting business within Indiana" because Development Corporation:

> Regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and results in receipts flowing to the taxpayer from within Indiana. IC § 6-5.5-3-1(6).

As Taxpayer explains, Development is a "wholly owned subsidiary" of a financial institution, is in the business of "originating and servicing loans" with Indiana customers, is part of Taxpayer's unitary group, and apparently should have been included in Taxpayer's combined FIT return.

FINDING

Taxpayer's protest is sustained subject to the Department's verification of Taxpayer's documentation.

V. Foreign Source Income Losses – Financial Institution Tax

DISCUSSION

The Department disallowed a certain portion of Taxpayer's foreign source income deduction on the ground that the Taxpayer did not "net" its gains and losses in the calculation here at issue. Taxpayer objects.

Taxpayer states that it entered into leases with foreign entities for equipment located in other countries. During 2008, Taxpayer had twenty-two outstanding equipment leases with foreign entities. Of the twenty-two leases, Taxpayer claims that sixteen produced positive income and six produced losses. On its original return, Taxpayer combined the income and losses from these leases and reported a net income. Taxpayer then excluded the net income amount in reliance on IC § 6-5.5-1-2(a)(2)(B). Taxpayer cites to this provision as authority for its position that the audit erred in making the adjustment as noted in the preceding paragraph. The provision on which Taxpayer relies provides as follows:

> (2) Subtract the following amounts...
>
> > (B) Income that is derived from sources outside the United States, as defined by the Internal Revenue Code.

According to Taxpayer, during the audit it "requested that twenty-two leases be considered separately and the income results attributable to the sixteen leases be subtracted under IC § 6-5.5-1-2(a)(2)(B)." Taxpayer claims that the losses from six of the leases should not be added back or netted against the income from the other sixteen leases.

Taxpayer cites to I.R.C. § 862(a) as specific authority for removing the income from the leases that produce positive income.

> (a) Gross income from sources without United States.--The following items of gross income shall be treated as income from sources without the United States:

(1) interest other than that derived from sources within the United States as provided in section 861(a)(1);
(2) dividends other than those derived from sources within the United States as provided in section 861(a)(2);
(3) compensation for labor or personal services performed without the United States;
(4) rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties. (Emphasis added).

Taxpayer concludes that IC § 6-5.5-1-2(a)(2)(B) provides for the subtraction of foreign income in computing adjusted gross income and that it does not require the adding back of losses from separate transactions in computing the amount of that income.

At the Department's request, Taxpayer has provided the following illustration of its position as follows:

[A] Taxpayer (lessor) entered into a number of leases with separate and independent lessees. Assume that Taxpayer has $30 in income from leasing property outside the United States and $20 in losses from separate leases of property located outside the United States. Taxpayer's gross income from other sources is $70. Taxpayer's federal taxable income is $80. In computing its adjusted gross income for purposes of the financial institutions tax, Taxpayer subtracts the $30 in income from foreign leases but does not add back the $20 in losses from foreign leases, resulting in Indiana adjusted gross income of $50.

Taxpayer argues that IC § 6-5.5-1-2(a)(2)(B) provides for the subtraction of foreign income in computing adjusted gross income. Taxpayer maintains that IC § 6-5.5-1-2(a)(2)(B) "does not require the adding back of losses from separate transactions in computing the amount of that income amount."

Taxpayer filed an amended return in which Taxpayer "subtracted" its "gross foreign source income" instead of its "federal taxable income" from sources outside the United States to arrive at "adjusted gross income" for Financial Institutions Tax purposes.

IC § 6-5.5-1-2(a) defines "adjusted gross income" for the Financial Institutions Tax, as follows:

Except as provided in subsections (b) through (d), "adjusted gross income" means taxable income as defined in Section 63 of the Internal Revenue Code, adjusted as follows:
(1) Add the following amounts:
(A) An amount equal to a deduction allowed or allowable under Section 166, Section 585, or Section 593 of the Internal Revenue Code.
(B) An amount equal to a deduction allowed or allowable under Section 170 of the Internal Revenue Code.
(C) An amount equal to a deduction or deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by a state of the United States or levied at the local level by any subdivision of a state of the United States.
(D) The amount of interest excluded under Section 103 of the Internal Revenue Code or under any other federal law, minus the associated expenses disallowed in the computation of taxable income under Section 265 of the Internal Revenue Code.
(E) An amount equal to the deduction allowed under Section 172 or 1212 of the Internal Revenue Code for net operating losses or net capital losses.
(F) For a taxpayer that is not a large bank (as defined in Section 585(c)(2) of the Internal Revenue Code), an amount equal to the recovery of a debt, or part of a debt, that becomes worthless to the extent a deduction was allowed from gross income in a prior taxable year under Section 166(a) of the Internal Revenue Code.
(G) Add the amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was placed in service.
(H) Add the amount necessary to make the adjusted gross income of any taxpayer that placed Section 179 property (as defined in Section 179 of the Internal Revenue Code) in service in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election for federal income tax purposes not been made for the year in which the property was placed in service to take deductions under Section 179 of the Internal Revenue Code in a total amount exceeding twenty-five thousand dollars ($25,000).
(I) Add an amount equal to the amount that a taxpayer claimed as a deduction for domestic production activities for the taxable year under Section 199 of the Internal Revenue Code for federal income tax purposes.
(2) Subtract the following amounts:
(A) Income that the United States Constitution or any statute of the United States prohibits from being used to measure the tax imposed by this chapter.

(B) Income that is derived from sources outside the United States, as defined by the Internal Revenue Code.
(C) An amount equal to a debt or part of a debt that becomes worthless, as permitted under Section 166(a) of the Internal Revenue Code.
(D) An amount equal to any bad debt reserves that are included in federal income because of accounting method changes required by Section 585(c)(3)(A) or Section 593 of the Internal Revenue Code.
(E) The amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation.
(F) The amount necessary to make the adjusted gross income of any taxpayer that placed Section 179 property (as defined in Section 179 of the Internal Revenue Code) in service in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election for federal income tax purposes not been made for the year in which the property was placed in service to take deductions under Section 179 of the Internal Revenue Code in a total amount exceeding twenty-five thousand dollars ($25,000). (Emphasis added).

Accordingly, to determine a taxpayer's "adjusted gross income" for Financial Institutions Tax purposes the Department starts with federal "taxable income" as defined by the Internal Revenue Code and then makes certain enumerated adjustments.

Federal "taxable income" includes the "taxable income" from sources outside the United States as defined at I.R.C. § 862(b), as follows:

From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expense, losses, or other deduction which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States.... (Emphasis added).

Therefore, it is this gross income net of "expenses, losses, and other deductions" amount that is included in Taxpayer's federal "taxable income." The "foreign source income" treated as federal taxable income is the foreign source gross income reduced by expenses, losses, and other deductions related to that income. If the "foreign source income" is actually a loss, then the loss deducted to reduce federal taxable income is the "foreign source income." Only those amounts of foreign source income minus the expenses, losses, and other deductions related to that income–as defined in the internal revenue code–are treated as federal taxable income. Thus, pursuant to IC § 6.5.5-1-2(a)(2)(B), it is this "net of expenses, losses, and other deductions" amount, defined as "taxable income" from foreign sources, that is subtracted from Taxpayer's federal "taxable income" to arrive at the Taxpayer's Indiana "adjusted gross income" for Financial Institutions Tax purposes.

The Department properly "subtracted" the federal "taxable income" that was derived from foreign sources to arrive at the Taxpayer's "adjusted gross income" for Financial Institutions Tax purposes.

FINDING

Taxpayer's protest is respectfully denied.

VI. Apportionment Numerator – Financial Institutions Tax

DISCUSSION

Taxpayer argues that the Department's audit erred because it did not correct an error in Taxpayer's own numerator. Taxpayer states that its own original return included "mortgage servicing fees" earned by "Mortgage Company," one of Taxpayer's related entities. Taxpayer states that the fees were erroneously sourced to the state in which the underlying collateral was located. Taxpayer reasons that because the Mortgage Company did not own the mortgage loans, the proper method of sourcing the "servicing fees" is provided for under IC § 6-5.5-4-10 as follows:

Receipts from the performance of fiduciary and other services must be attributed to the state in which the benefits of the services are consumed. If the benefits are consumed in more than one (1) state, the receipts from those benefits must be apportioned to Indiana on a pro rata basis according to the portion of the benefits consumed in Indiana.

Taxpayer explains that residential mortgages are originated by "Mortgage Company" and "Mortgage II." Mortgage II sells its mortgages to "Mortgage Company" which thereafter aggregated the loans into "pools" and sells the loans to investors. "Mortgage Company" continues to service the underlying mortgages. During the years at issue, the mortgages were primarily sold to "Freddie Mac," "Fannie Mae," and "Ginnie Mae."

The services provided by "Mortgage Company" included invoicing monthly mortgage payments along with escrow amounts; applying the payment received to principal, interest, and escrow; paying funds due to the investor; confirming that property payments are insured against loss; and enforcing collection actions against delinquent borrowers.

For illustrative purposes only and based upon the information provided, the transactions at issue are explained as follows:

• "Mortgage Company" enters into home loan agreements with customers in Indiana and Ohio;

• "Mortgage II" also enters into home loan agreements with customers in Indiana and Ohio;
• "Mortgage II" sells to Mortgage Company its entire portfolio of Indiana and Ohio mortgages;
• "Mortgage Company" packages all the Indiana and Ohio Mortgages – both its own mortgages and the mortgages it acquired from "Mortgage II" – and sells those loans to Freddie Mac, Fannie Mae, and Ginnie Mae.
• "Mortgage Company" continues to service the loans now owned by Freddie Mac, Fannie Mae, and Ginnie Mae. The Indiana and Ohio homeowners send their monthly mortgage payments to "Mortgage Company."
• "Mortgage Company" applies the interest and principal payments to the proper accounts, keeps the records, enforces the loans and – at the end of the day – keeps a portion of the mortgage payments as compensation for the services it conducts on behalf of Freddie Mac, Fannie Mae, and Ginnie Mae.

Taxpayer asks that a reduction in the numerator of its receipts factor be made. Taxpayer states that, "[T]he benefits of its mortgage servicing activities were consumed at the locations of the mortgage loan purchasers outside Indiana." Presumably Taxpayer wants the service receipts attributed to the location of Freddie Mac, Fannie Mae, and Ginnie Mae.

The Department finds little support from Taxpayer's contention that the money earned from "servicing" these home loans must be "sourced" to the holder of the loans. Taxpayer is earning money from Indiana customers who borrowed money to purchase Indiana homes; the proper attribution statute is found at IC § 6-5.5-4-4 which states:

Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property must be attributed to Indiana if the security or sale property is located in Indiana.

The servicing fees at issue constitute "receipts from assets in the nature of loans or installments sales contracts that are primarily secured or deal with real or tangible personal property...." As IC § 6-5.5-4-4 conclusively states, those receipts are "attributed to Indiana...." because the secured property is located in Indiana.

FINDING

Taxpayer's protest is respectfully denied.

VII. Underpayment Penalty – Financial Institutions Tax

DISCUSSION

The Department concluded that Taxpayer underpaid its quarterly estimated income tax payments for 2006, 2007, and 2008 and assessed a penalty.

Any "underpayment" penalty is based on IC § 6-5.5-6-3(a):

Each taxpayer subject to taxation under this article shall report and pay quarterly an estimated tax equal to twenty-five percent (25[percent]) of the taxpayer's total estimated tax liability imposed by this article for the taxable year. A taxpayer that uses a taxable year that ends on December 31 shall file the taxpayer's estimated quarterly financial institutions tax return and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year, without assessment or notice and demand from the department. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing the estimated quarterly financial institutions tax return and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and furnish the forms for reporting and payment.

The penalty for underpayment of quarterly estimated income tax payments is based on IC § 6-5.5-7-1 as follows:

(a) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on a taxpayer who fails to make payments as required in IC 6-5.5-6. However, no penalty shall be assessed for a quarterly payment if the payment equals or exceeds:

(1) twenty percent (20[percent]) of the final tax liability for the taxable year; or
(2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.

(b) The penalty for an underpayment of tax on a quarterly return shall only be assessed on the difference between the actual amount paid by the taxpayer on the quarterly return and the lesser of:

(1) twenty percent (20[percent]) of the taxpayer's final tax liability for the taxable year; or
(2) twenty-five percent (25[percent]) of the taxpayer's final tax liability for the taxpayer's previous taxable year.

Taxpayer states that the underpayment penalty is based upon the "FIT liability determined by the Department on audit." Taxpayer "submits that this interpretation is inconsistent with the legislative purpose for imposing an estimated tax penalty, which is to ensure that taxpayers timely pre-pay liabilities during the taxable year and before reporting the actual liability for the taxable year as reflected on their final returns." Taxpayer concludes that "[t]he penalty or underpayment of estimated FIT liability must be determined based on the basis of the amount of FIT reported on the original returns as filed."

The Department takes no position as to whether the underpayment penalty should ever be calculated based on what Taxpayer reports on its original return or whether the penalty should ever be calculated based upon the amount for which Taxpayer is ultimately found liable. However, based upon the nature of the tax, the amount of tax involved, the issues raised by both Taxpayer and the audit, the Department is prepared to agree that the underpayment penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the Department's treatment of the interchange fees as set out in Part I above is sustained; the audit/enforcement division is requested to review the numerator calculation as described in part II; Taxpayer's argument in Part IV, that "Development Corporation" should have been included in the originally filed FIT returns, is sustained; Taxpayer's challenge to the imposition of the underpayment penalty is sustained; in all other respects, Taxpayer's protest is denied.

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